

## **China's Banking Reform: Problems and Potential Solutions**

Charles Goodhart, Xiaosong Zeng <sup>1</sup>

### **A. Introduction**

China's financial system has been undergoing major reforms during the last decade, with the aim of establishing a modern commercial banking system and the development of stock market(s). In recent years there have been large capital injections into ailing state-owned banks, and currently encouragement for them to explore IPOs, as well as bail-outs of bankrupt securities firms by state-owned investment companies.

We acknowledge the considerable progress already made in reforming the banking system, but we feel that there are still questions that need to be asked. For example, exactly what is the core of the fundamental problem(s) with the banking system in China? What is the best path to take to address such problems?

We note that there remain worrying current developments:-

#### **(1) The asset quality of state-owned banks is still a concern**

Based on the latest statistics, released in July 2005 by the China Banking Regulatory Commission (CBRC), the regulator of commercial banks and lending institutions in China, as of June 30, 2005, the NPL balance of state-owned banks was RMB1,013.5 billion, which is RMB903.3 billion less than the RMB1,916.8 billion as of December 31, 2003. However, after adjusting for the transfer of NPLs of RMB634 billion from ICBC, RMB254 billion from BOC, and RMB9.5 billion from CCB, the NPL balance of state-owned banks would be RMB1,911.0 billion, not significantly lower than its 2003 level.

Moreover, we are concerned about the soaring totals of Special Mentioned Loans, which can be used to hide NPLs. Taking the three forefront banks in the restructuring, CCB, BOC, and BoComm, as example, we observe that the combined balance of their special mention (SM) loans rose 22.4%, to RMB731 billion in 2004. Also, if the NPLs transferred to AMC's are included back into the NPLs, the combined impaired loan balance (i.e. NPLs plus SM loans) would grow by RMB190 billion from the end of 2003. Accordingly, their impaired loan ratio would grow by 2.21 percentage points to 28.47% from 26.27% during the same period.

The NPL increase in the first half of 2005 was primarily related to new loans made in 2003 and 2004, when the economic cycle of China peaked. In 2003, annual GDP growth was over 9% and banks made roughly RMB3,000 billion new loans, among which RMB1,679 billion was made by the "Big-four" state-owned banks. In addition to their desire for profitability, (which also enables them to make larger provisions for NPLs without being forced to show an accounting loss), banks benefit from making new loans because it dilutes the NPL ratio. Indeed, there are some suggestions that bank expansion has been partly driven by pressure from regulators to reduce NPL ratios. But if such new loans then generate the same proportion of NPLs, or even worse a higher ratio, the strategy will be self-defeating.

---

<sup>1</sup> Charles Goodhart is an emeritus professor with the Financial Markets Group of the London School of Economics and a past member of the Monetary Policy Committee of Bank of England, and Xiaosong Zeng, CFA, is a senior analyst with a global investment bank. This paper reflects entirely the authors' personal views and does not represent the views of any other entity or institution. The authors are grateful to Professor Mervyn K. Lewis for comments on this paper and Mr. Andrew Sheng for comments on part of this paper.

In any case such a strategy of trying to grow out of trouble came to an end in April 2004, when the central government took action to cool down the overheated economy, and to curb the bubble in real estate market. We are concerned about the banking system's vulnerability to a credit cycle downturn, since their NPL ratios could further deteriorate if the economy should grow significantly less fast, and if the real estate market in metropolitan cities like Shanghai should encounter price declines.

(2) Tax-payers and depositors continue to subsidize State-owned banks

In any case, an easing of the government's "Macro-Adjustment" might not be helpful in alleviating the NPL levels of commercial banks if the fundamental problem is not properly solved, and NPLs incurred on new loans remain large. Moreover, in early August, several state media reported that commercial banks may increase the rate of new lending in the second half of 2005, due to increasing deposit and newly injected capital. The target for new loans in 2005, set by the People's Bank of China, is roughly RMB2,500 billion, and commercial banks made RMB1,450 million, or 58% of the annual target, during the first half of 2005, lower than the historical average of 60%; so commercial banks are expected to be more aggressive in their lending policy in the second half of this year. A potential concern is the new NPLs generated for the next several years by current new lending.

The government injected substantial capital into the "Big-three" state-owned banks, and took over a large proportion of their NPLs. The next in line for rescue is the fourth largest bank in China. After that all state-owned banks in China will have been rescued with money from tax payers, many of whom are also depositors of these banks. The rescue of state-owned banks is followed by the government's bail-out of bankrupt securities firms. Will such government rescues solve the fundamental problems of China's banking system? How far, if at all, do such rescues, and subsidies, solve the basic problems of China's banking system? Might they not even make them worse by reducing banks' concern to check and monitor the viability of existing and proposed loan business (moral hazard and adverse selection). Depositors at the big four state-owned commercial banks already enjoy implicit 100% deposit insurance, but might moral hazard issues range more widely if China establishes the Deposit Insurance Scheme (DIS), which is scheduled to be launched later this year (2005) or next (2006).

(3) Banks' loan margins are too low to generate a proper return on capital and strengthen the Capital Adequacy Ratio

The revenue of commercial banks in China is highly dependent on corporate loan business; it accounted for over 80% of the "Big-four" state-owned banks' revenue in 2004 on average. But the loan margins on such business are too low to generate a sufficient risk-adjusted return (e.g. Risk Adjusted Return on Capital or RAROC) and Capital Adequacy Ratio. Given the rapid growth of deposits, due to the high savings rate of individuals and lack of alternative financial investment opportunities, bank capital must also increase in line to maintain capital adequacy. Net revenues have been too low to generate sufficient profitability to maintain RAROC. Part of the solution must be to increase margins by some combination of reduction on deposit interest and/or increase in lending rates. But this latter could raise NPLs ever further via adverse selection.

(4) Capital adequacy ratio is low

The CAR of Chinese banks is low, with the highest no more than 12%, and the highest among the five A-share banks no more than 10%, in contrast to the average ratio over 18% of Hong Kong listed banks:

Table 1: Capital Adequacy of Hong Kong banks

	<u>Tier 1 ratio (%)</u>			<u>Total Capital Adequacy Ratio (%)</u>		
	2002	2003	2004	2002	2003	2004
<b>Hong Kong banks</b>						
Bank of China-HK (HK\$)	13.11	14.22	15.19	13.99	15.11	16.14
Bank of East Asia (HK\$)	12.36	13.01	12.27	16.90	17.20	16.20
CITIC International Financial (HK\$)	10.03	10.18	10.47	18.24	16.46	15.68
Dah Sing Banking Group (HK\$)	15.05	15.78	13.59	19.81	20.32	17.10
Dah Sing Finance Holdings (HK\$)	15.12	15.84	13.75	19.90	20.40	17.30
Hang Seng (HK\$)	11.90	11.53	11.25	14.24	13.38	12.53
HSBC Holdings (US\$)	9.67	10.45	10.30	13.25	12.94	12.33
ICBC Asia (HK\$)	10.94	9.33	10.04	17.90	16.70	17.40
International Bank of Asia (HK\$)	21.45	18.38	14.89	21.86	18.73	15.18
JCG (HK\$)	37.50	41.56	40.50	38.96	43.17	42.09
Liu Chong Hing Bank (HK\$)	19.60	19.00	19.00	20.09	20.00	20.00
Standard Chartered (US\$)	8.62	8.77	8.64	14.48	14.63	14.96
Wing Hang (HK\$)	15.40	15.55	10.25	16.50	16.50	15.70
Wing Lung Bank (HK\$)	18.44	19.18	18.28	21.10	21.50	20.50
<b>Average</b>	<b>15.66</b>	<b>15.91</b>	<b>14.89</b>	<b>19.09</b>	<b>19.07</b>	<b>18.08</b>

Though CBRC is requiring all Chinese banks to achieve a CAR no lower than 8% by the end of 2006, we are not sure whether these banks can achieve this goal by the due date. The current temporary freeze of secondary offers in the A-share market will cut off another route for raising equity.

(5) Reliability of data is still questionable

The reliability of accounting data, such as the loan classification and loan loss provisions, is critical for the assessment of the soundness of banks. The wide-spread doubts over Chinese banks' financial data are due to concern over the quality of banks' auditing procedure, standard, and control.

### **B. What are the fundamental problems with China's banking system?**

In our view, the fundamental problems with China's banking system are the interdependence between banks and State-Owned Enterprises (SOEs), the way that banks are run as SOEs, and government's improper influences on the operations of SOEs and banks. Though these problems have been around for a long time and are deeply rooted, we do not believe that these problems have been really solved. In our opinion, without a thorough reform of the SOEs and the way that banks are run as SOEs, the problems with China's banking system will never be really solved, even after the banks are (partially) relieved of current NPLs, invested by minority foreign bank share-holders, and listed on the stock exchange.

The history of China's SOEs has made them very different from the profit-maximising firms of market economies. Traditionally, SOEs provided a set of social services to their employees and their families, and have usually been used to solve the unemployment problem and alleviate the social burden on the government; in developed economy enterprises are less influenced by local government, have better corporate governance structure, and less social burden. Whereas China has been trying to establish a "Modern Enterprise System" by transforming many SOEs into shareholding companies and also to shift the provision of social security to the State, the SOE reform has been only partial and incomplete. Profit maximisation is still not the sole objective for an SOE; besides initially fulfilling the quantitative objectives of the production plan (not necessarily profit plan) set by either the central government (if the

SOE is large enough and is categorized as a "Central Level Enterprise") or local government, SOEs also shoulder the burden of providing tax (and other, sometime dark) revenues and employment (from time to time to retiring government officials).

For all these reasons, the ability of an SOE to generate profits is neither the sole criterion of success nor determines its ability to continue in existence. SOEs have rarely been subject to a hard-budget constraint, neither are they subject to bankruptcy if they could not meet their debts. The state-control of ownership also makes the take-over of an underperforming SOE less likely, (unless the enormous loss of a SOE affects the employment target, makes it lose its various values for the government, or it is perceived to be too weak to be turned around by the government-appointed management team). Nor is the management of a typical SOE subject to a well-structured incentive plan, which rewards the management based on the performance of the firm. Also, the management of SOEs and typical banks usually carry a political rank comparable to government officials, and they participate in political activities from time to time, so political influence on SOEs and banks is virtually unavoidable. Moreover, general managers of SOEs may be politically more senior than those of banks in the system, making it very difficult for banks to say no to borrowing requests from these SOEs.

The inefficiency of SOEs has had fiscal/financial consequences. Under a centrally planned system, the banking system plays little role in allocating capital, and state-owned banks extend loans as, and when, required to finance plan allocations. So there was originally little concern in the banks for managing the risk of loan losses or non-performing loans. Even after the move towards a market-oriented economy, there was a continuing, in part politically driven, desire to enable many (perhaps most, as represented by total employment) loss-making SOEs to continue in operation.

The problem has been how to finance this. The big four commercial banks traditionally have done much of this, a (hidden) form of fiscal subsidy. Given the difficulties, and disadvantages, within China of raising additional tax revenues to take over the remaining social functions from SOEs (and of paying unemployment benefits to ease the redeployment of labour from inefficient, closed SOEs), the incentive to local governments to continue using the commercial banks as an informal fiscal piggy-bank was enormous.

In contrast, Non-SOEs (NSOEs), or private enterprises, have more difficulty in obtaining finance from the state-owned banks, due either to implicit discrimination against private enterprises and favouritism shown to the SOEs or the inadequacy of good collateral because of the insecurity of property rights in China. The central bank and CBRC may have realized the problem and started addressing this issue by encouraging micro-loans and small and medium loans (SMEs) recently.

The syndrome of subsidy to SOEs from state-owned banks went further. The stock market has been seen as another way to provide a quasi-fiscal subsidy to SOEs, (not so much as a means of allocating capital efficiently). Many, though not all, of the SOEs chosen for listing and IPOs were so selected not because they were the best performing SOEs, but because they were most in need of an infusion of extra funding. . The result of this has been that many of the SOEs listed on the Shenzhen and Shanghai stock markets have failed to make profits or to distribute any dividends, with many becoming the target of speculative trading and finally became 'shell' companies. Management of many listed companies, no matter how poor is their performance, are not subject to the risk of being replaced, as the majority shares are still controlled by the government or legal entities affiliated to the government. Partly as a consequence, equity prices on the two Stock Exchanges have trended downwards, causing upset (to say the least amongst their investors), and making the regulator unwilling to authorize any further new listings (of whatever quality) and even opposed to other initiatives (such as controlled portfolio outflows into foreign assets, via QDII) that might provide alternative (and better performing) investments than the local Stock Exchanges. So, despite the Stock Markets having been operating for the better part of 10 years, neither

the equity – nor, partly for other reasons, the corporate bond market – (i.e. the capital markets) have played an efficient role in the intermediation of saving and investment, or in the allocation of capital in PRC. This government has realized this problem and has tried to permit the sales and trading of such “non-tradable shares” of domestically listed companies, as we will discuss in the later part of this paper.

Since making losses did not (quasi-automatically) lead to closure and the dismissal of the management, SOE managers have been in many cases effectively on a soft-budget constraint. Moreover, the bigger an enterprise, the harder it usually is to close, because of the resultant effects on the local economy. So management of SOEs usually have had an incentive to invest and to expand, in some large part without much concern for relative prices, notably interest rates. If the investment is successful, they – the managers – obtain much of the benefit. Losses, and failures, can be largely passed on to the banking system – banks and equity investors. There is a built-in incentive to expand output, and employment, but not the return on capital.

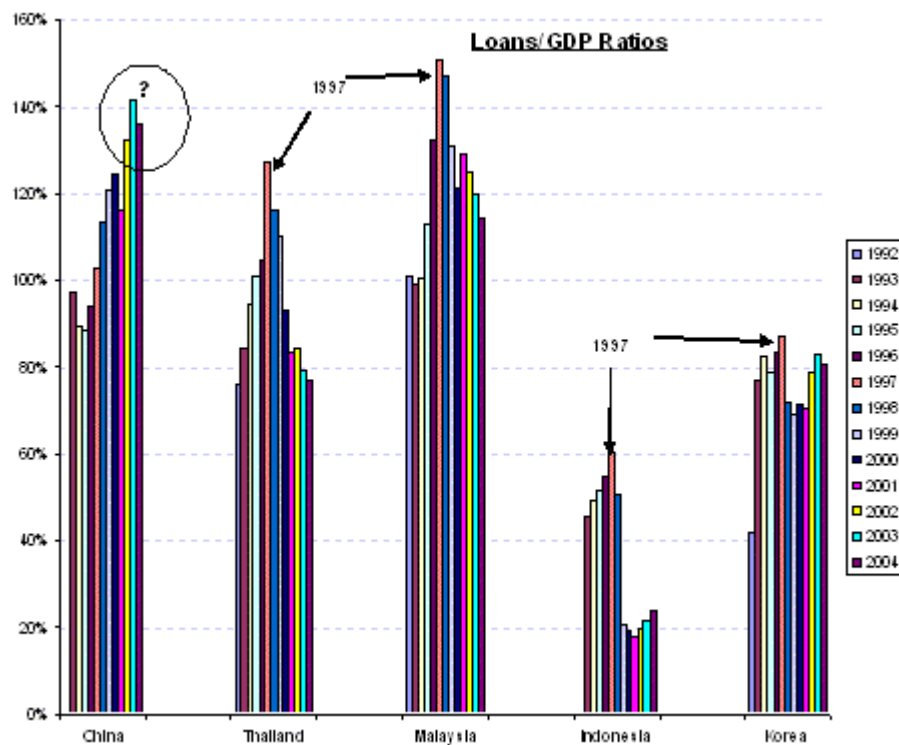
Given their historical background in financing SOEs, the banks accumulated a large proportionate volume of NPLs. which, if on a rigorous accounting basis, could endanger the solvency of the main commercial banks. This has meant that state-owned banks too have been on a soft budget basis. From time to time the authorities have tried to ‘clean up’ the banks by transferring old NPLs to asset management companies (which have their own incentive problems – not discussed here), and shifting strategic investment financing onto the policy banks (whose operations appear neither well-defined nor transparent - also not discussed further here), and injecting new assets – most recently US Treasury bonds – into the banks in the place of the transferred NPLs.

This has been, at best, a partial success. One reason for this is that the banks have only in practice been able to transfer a proportion of their existing NPLs to the AMCs. Much more important is that the incentive of the government and bank to make new loans to (potentially or probably) underperforming SOEs remains strong. Not only are the banks still on a soft-budget basis, but in the event of a bankruptcy, or closure, a bank ranks low amongst creditors. ‘Ever-greening’, i.e. carrying loss-making SOEs, avoids political ructions and making large losses concrete on the books. Banks have become what is known as ‘passive creditors’.

Even when the government sets some goals, such as the minimum capital adequacy ratio (CAR) and maximum NPL ratio, for banks receiving capital injections, banks can use accounting window-dressing and other measures to achieve such goals. For example, to achieve the goal of CAR, some banks consider temporarily selling some risky assets at the end of the year to other banks without such CAR pressure (say, banks with higher CAR or very low CAR). And as we discussed in the earlier part of this paper, many banks try to rapidly increase their asset size, which is not only helpful to dilute the NPL ratio and to expand the amount of profits (but not the profitability, such as net interest margin and ROA).

We are concerned about the rapid growth of bank loans, which, measured by the ratio of total loans/GDP, has been higher since 2003 than that of Thailand, Indonesia and Korea in 1997, the year immediately prior to the Asian Financial Crises in 1998, and just slightly lower than that of Malaysia in 1997, as shown in the chart below:

Figure 1: Loans/GDP ratio of China compared with countries hurt by Asian Financial Crises, 1992-2004



Source: Sunil Garg

Moreover, state-owned banks, like SOEs, are majority owned and run by the government. In particular senior management is appointed by the government based on various factors and considerations, instead of being selected from the market, based on track records and experience in bank management. And we do not believe that this will be fundamentally changed even after their respective IPOs, based on the listings of several banks either domestically or overseas. As the management of state-owned banks and SOEs are generally colleagues within the governmental or political system, it is not an easy job for state-owned banks to decline making loans to many SOEs. It is actually not unusual for state-owned banks to favour even loss-making SOEs against better performing NSOEs like private enterprises, which sometimes have either to borrow from an “underground banking house” or restrict the scale of investment. That being said, we are not arguing that SOEs always underperform NSOEs, or SOEs are the only source of PRC banks’ problem loans.

Also, the compensation of SOE and state-owned bank's management, as we previously discussed, could distort the incentive structure of SOEs<sup>2</sup>. If, as usual in China, political cadres are transferred by the government to banks, and the reward to a successful banker of a state-owned bank is the promotion/transfer by the government to a senior position within the political system, it will be difficult for the management of state-owned banks to set ROE maximization and risk control as their foremost objectives and resist political pressure or benefit to make loans to support local economic growth. Bankers grown from the political system are also less professional in banking skills and risk management, which are more and more complicated and challenging in today's financial world.

<sup>2</sup> See Xiaosong Zeng, “The constraints and Solution in the Reform of State-owned Enterprises”, *Wuhan University Academic Journal*, October 1995.

This conjuncture also reduces the effectiveness of market-oriented monetary policy. Since they are subject to soft budgets, the SOEs (and the banks) pay relatively little attention to price signals, i.e. to the level of interest rates. Indeed in China from time to time a rise in interest rates has the perverse effect of shifting resources to relatively low-return enterprises like SOEs, who may ignore rising interest rates and away from other NSOEs who do respond to price signals.

Finally, but not least, we note that the management of SOEs and state-owned banks who violated lending policies and procedures, or even broke laws, were not always disciplined via legal procedures – many of them were disciplined via the government’s internal political system instead. Those who got prosecuted or put in prison were usually connected with scandals involving foreign jurisdictions (e.g. in the U.S. and Hong Kong) and exposed by foreign media.

### **C. Some Proposals for the SOE reform in China**

China has done much to reform SOEs, ranging from the establishment of a “Modern Enterprise System” to the listing of some SOEs in the stock markets, domestically and even internationally. Nevertheless there remain outstanding questions whether underperforming firms have been penalized by higher financing costs, management restructuring, and even bankruptcy? And have good firms been rewarded by a reduced cost of capital? If not, the capital market did not properly play its role in disciplining the corporate sector through its lending and fund-raising functions. We believe that the ultimate success of reforms of SOEs and banks will require an effective capital market.

The most recent efforts of the government to make state-owned shares of listed companies tradable in the stock market appears a move in the right direction, even though the way to implement the reform, the fairness of the valuation for the holders of tradable shares versus non-tradable shares, as well as the freezing of secondary offerings or overseas listing, are widely debated. The effectiveness of this reform remains to be seen.

Preconditions for the establishment of an effective capital market

There are, of course, many pre-conditions for the establishment of an effective capital market in China, but the following needs to be emphasized:

#### **1. Improve the information infrastructure**

There must be adequate information disclosure and enforcement of that by regulators. The quality of information disclosure is dependant on the professional infrastructure, notably the availability of clearly-defined accounting standards and the establishment of a financial professional system, within which professionals, such as well-trained accountants and security analysts, can adequately analyze the financial conditions of a company. If accurate public information on the financial position of enterprises is scarce and of uncertain reliability, it will be difficult for investors to allocate funds efficiently. This uncertainty may serve to divert funds from capital markets to the banks, which are (correctly and properly) perceived as having implicit 100% protection.

Financial regulators should focus on surveillance of disclosure quality, strictly enforce disclosure rules, and make the management shown to be responsible for false disclosure or fraudulent practice accountable for their actions (Zeng 1997<sup>3</sup>). Whereas numerous securities’ regulations and rules have been enacted in China, their enforcement, in particular its timeliness, strictness, and effectiveness, is critical. Financial

---

<sup>3</sup> Xiaosong Zeng, “On Information Disclosure and Financial Regulation”, International Financial Studies, September 1997.

regulators should also try to establish an effective incentive structure in financial regulation (Goodhart, 1996<sup>4</sup>, Zeng 1997<sup>5</sup>).

## 2. Strengthen creditors' rights

There is a need to establish an effective legal system for the enforcement of bankruptcy laws. In many emerging soft-budget countries, the law, especially bankruptcy laws, are strongly biased towards debtors, and/or the legal system is lax in enforcing the law. The weakness of banks' positions as a creditor of a failed company has already been mentioned. Furthermore the ability of a secured creditor to foreclose on a defaulting mortgage is strictly limited. Unless bond holders possess covenants that enable them to control and replace management and to realise collateral before all the assets are depleted, such bond holders stand at severe risk of being dispossessed. In the case of bonds issued by SOEs in China, it is far from clear what security a bond holder would have, and there may be many grey areas in the enforcement of bondholder's claim against such security in a bankruptcy. Under such conditions it is, perhaps, not surprising that no corporate bond market has yet developed. We recognize that the government has taken a more proactive approach to develop the corporate bond market, such as the recent approval by the State Reform and Development Commission for several "Central Level" SOEs to issue bonds in the second half of 2005; it remains unclear, however, why the debt issuance quota, which is perceived as a scarce resource in China, has been primarily awarded to SOEs, why bond issuance is decided by government officials, rather than by the shareholders of the companies involved, and what the rationale behind the official approval/denial has been.

## 3. Improve managerial incentive structures

An effective incentive structure for SOE's management should be established. The performance of a firm, either a SOE or a bank, depends on the effort and quality of its management. This is true no matter whether a firm's stock is listed or not. In order to establish an effective incentive structure to motivate the management to maximize the ROE, it is necessary to reward management for out-performance and hold the management accountable for underperformance and/or mismanagement (Zeng 1997)<sup>6</sup>. As previously analyzed, to reward an outperforming SOE manager by promoting her/him to a senior position within the political system is not an economically effective incentive structure, and does not generate an appropriate interest alignment between the management and shareholders of a firm. Evidence in developed market economies has demonstrated that it is more effective to recognize, measure and financially reward the managerial expertise of managers. The scheme of awarding Executive Stock Options (ESO) is a useful tool for the establishment of an effective incentive structure for SOE management, and its structure, pitfalls, and improvements were analyzed by us back to 1998<sup>7</sup>.

## 4 ☐ The corporate governance structure needs re-enforcing.

Corporate governance generally refers to the system of checks and balances that ensures that corporate management, boards of directors, various board committees, executives, auditors and corporate advisers, all carry out their fiduciary responsibilities owed to those they represent.

---

<sup>4</sup> Charles Goodhart, The Incentive Structure in Financial Regulation, Financial Studies (Chinese), December 1997.

<sup>5</sup> Xiaosong Zeng, "Deposit Insurance System: Operations, Pitfalls, and Improvements", Securities Market Herald, September 1997.

<sup>6</sup> Xiaosong Zeng, "The constraints and Solution in the Reform of State-owned Enterprises", Wuhan University Academic Journal, October 1995.

<sup>7</sup> Xiaosong Zeng, "Executive Stock Option Scheme: Structure, Accounting Recognition, Pitfalls, and Improvements", Securities Market Herald, April 1998.



A paper examining how corporate governance is closely related to capital market development in particular and property rights infrastructure in general (Sheng, Xiao and Wang 2005<sup>8</sup>) suggests that good corporate governance relies heavily on an array of supporting institutions, or the property rights infrastructure (PRI). Sheng et al. argue that a major task in the transition from a planned economy to a market economy is to build a strong and well-functioning PRI. Good corporate governance and a competitive market economy can only be built upon a strong PRI.

As described in that paper, the essential elements of a modern PRI include the following institutions grouped in three broad categories:

(I) Institutions for delineation of property rights

- A Central Registry of property right [e.g. land registry, share registry] to provide an official record of property rights. This is crucial for transparency of property rights and reducing the costs of enforcement.
- Accounting and legal processes to define property rights (annual audits and the right of lawsuit to protect property right).

(II) Institutions for the exchange of property rights

- Trading processes (such as a stock exchange trading platform to enable transparent trading of property rights, and public auctions).
- Clearing, settlement and payment infrastructure (clearing house and payment system operated by banking system to enable transfers to be cleared and settled in final form through delivery of property rights).
- Regulated intermediaries (intermediaries who participate in the transfer process should be sanctioned if they do not perform according to the rules of the game).

(III) Institutions for enforcement and fine-tuning of property rights

- Rules of Game: norms, standards, codes, regulations, and law that help protect the property rights of participants against abuses of the system.
- Enforcement infrastructure: there must exist regulators to enforce the rules but enforcement costs should not exceed benefits to markets.
- Independent and transparent judiciary to adjudicate disputes over property rights.
- Transparent media and disclosure regime to ensure that property rights can be independently verified and accountable (e.g. disclosure rules and mandatory publication of financial statements).

Sheng et al. believe that, in a well functioning market, the PRI essentially functions to vet the entry of market participants, ensure that they perform to market and ethical norms and those that damage public

---

<sup>8</sup> Andrew Sheng, Xiao Geng and Wang Yuan, “Corporate Governance and Property Rights Infrastructure: The experiences of Hong Kong and Lessons for China”, Revised for Chapter 6 in China Conference Volume, “Policy Reform and Chinese Markets: Progress and Challenges”, Stanford University Press, 2003.

interest through inefficiency or misconduct (theft or fraud) exit the market. Each sector of the (financial) system will have different PRI, such as the trading, clearing and settlement system for the securities market. If the PRI is defective, then the property rights are not protected, and indeed may well be expropriated by players that are inefficient, loss making and in effect subsidized by the rest of the market.

Hernando de Soto (2000) has uncovered six hidden benefits of private property:

- Enabling the economic potential of assets (efficient use of capital).
- Integrating dispersed information into one system (economy of scale in PRI and standards and low transaction costs).
- Making people accountable (private property as an ultimate guarantee on contract fulfilment or fulfilment of responsibility).
- Making assets fungible (allow convergence of risk-adjusted return on various assets).
- Networking people (increasing the extent of the market and facilitating specialization).
- Protecting transactions (low enforcement costs when private property can be used as collateral and reduce transaction costs).

Sheng et al. pointed out that the Latin American experience shows that weaknesses in the PRI gives rise to a system that is not accountable, not fungible, with no network benefits, and little trading. Consequently, there is no credit culture. Ultimately, the poor are disadvantaged because the costs of entry into business becomes overwhelmingly high for small enterprises and poor people, while large enterprises can engage in regulatory capture to protect their vested interests against competition. When PRI is defective, transactions costs are high due to high risks and/or rent-seeking activities.

We also agree with Sheng, et al., that PRI is a public good that requires a large investment to establish, but it can generate sustained benefits in the form of drastically reduced transaction costs in the economy. This is why the government has a responsibility for building a well-functioning PRI as soon as possible if the society wants a modern market economy. It will be very difficult to revitalize the SOEs, and then the banking system in China, in the absence of a well defined and protected PRI.

Strict enforcement of laws and regulations

To ensure the effectiveness of a capital market, China also needs to improve the enforcement of laws, rules, and regulations. We witness that China has enacted more and more laws and regulations, but their enforcement is less satisfactory. In a market without discipline it is difficult to avoid problems like adverse selection. Political influence in the investigation and law enforcement process should also be eliminated.

Transferring of SOE's social functions to the government

Finally, we believe that it is important to clarify, standardise and quantify the issue of which social functions should remain with SOEs (and NSOEs), and which should be the responsibility of the government. The cost of transferring such functions to the state would be offset in part by higher profit taxes, which is explicit and transparent.

Even after being released from the need to provide some social functions, there would still be loss-making SOEs; perhaps in some cases because these were seen as strategic, and sometimes monopolistic, institutions whose prices remained subject to control. Railroads and Post Offices have been common

examples in Western market economies; no doubt there would be more in a Socialist market economy. Nevertheless the questions remain, who should decide which loss-making SOEs should continue to be supported, on what principles, criteria, should such decisions be made (e.g. cost/benefit), what is the likely net cost of such decisions, and, for the purpose of this paper on the reform of the financial sector, who should bear that cost? The argument made out here is that the cost should NOT be shouldered in the form of a hidden subsidy from the banks to loss-making SOEs in the guise of rising NPLs. The need is to make the cost of SOE social provisions and the support of loss-making SOEs open and transparent, and justified on fiscal grounds.

We see signs that the Chinese government is moving on the right direction to gradually downsize SOEs. The chairman of the State Council's State-owned Assets Supervisory and Administration Commission (SASAC), a government authority overseeing the largest SOEs as state shareholders, recently told media he would reduce the number of large SOEs controlled by SASAC to around 80-100 from the current 196. For us, there is no need for the government to worry about the loss of control of the economy after reducing the number of SOEs via, say, the sale of state-owned shares, as the government receives cash from such sales and can use the cash for other uses that are more in line with the government's missions, e.g. to replenish the social security fund.

#### **D. What is the way forward for Chinese banks?**

When the governments of many emerging market countries have not been able to find sufficient tax revenues to support those loss-making SOEs that it has wanted to maintain, they incline to use the banking system, banks and equity markets, as a subsidiary source of funding for this purpose, thereby, as an unintended by-product, undermining the efficiency, and profitability of the banking system.

If the main commercial banks continue to be used as supplementary fiscal piggy-banks, then it is doubtful whether any interim measures to inject capital and clean-up the banks will succeed for long.

Even if such reforms could be enacted, and it would probably take quite a long time - a worthy objective for a five-year strategic plan? – the culture of the main commercial banks has, we believe, been, at least in part, that of a soft-budget partner of the government and (loss-making) SOE rather than an efficient profit-maximising bank with effective risk management and internal control processes. In this latter respect the involvement of some of the best and most sophisticated Western banks in investment schemes with the main commercial banks seems, on this view, to be a major step in the right direction, as is the grant of more independence to the commercial banks to refuse (politically supported) potentially loss-making loans to SOEs. Indeed, the issue of how to handle the entry of, and competition from, foreign banks under the WTO seems to be being handled smoothly at present.

That said, it may be premature to press ahead with stock listing, and equity market introductions, of the big four commercial banks until the question of banks' involvement in the finance of loss-making SOEs is satisfactorily and finally resolved. Once the issue of the continuing flow of new NPLs from additional loans to loss-making SOEs is resolved, the question of how to handle the existing stock of NPLs is simple in principle, though their subsequent handling in AMCs, and the incentives for AMC managers, needs further consideration.

So we believe that the reform of the banks depends on the reform of the SOEs, and the reform of capital markets depends in some large part on the reform of the banks. The SMEs, especially NSOEs, should borrow from the banks, while the larger (profitable) enterprises, both SOE and NSOE, should finance themselves more in the capital markets, (both equity and bond). But, as already noted, given the government's inclination to use banks to fund loss-making SOEs, macro monetary control is attempted via direct credit controls and interest rates are held low, as one of the implicit subsidies to such SOEs. So

often there is no incentive for large enterprises to go to the capital market, while SMEs are usually unable to access either bank loans or the capital market.

If SOEs could be put on a hard budget basis, then interest rates could be freed up to act as a market mechanism. Given the spread that banks charge, that should act as an incentive for the better large-scale enterprises to go to capital markets for funding.

At the moment the financial regulators act not only as a regulator, but also as a manager of financial institutions and the controller (together with the political authorities) of new issues of IPOs and of corporate bonds. It is far from clear whether this is really effective or efficient. As argued before, we believe that financial regulators should focus on setting and enforcing the rules, identifying false disclosure, disciplining fraudulent practice by market participants, and nurturing a fair and orderly competition environment. Financial regulators should also encourage the development of market discipline and ethics among financial professionals. This brings us back to the need for the establishment of a Property Rights Infrastructure to assist in the provision of fair disclosure, a financial professional system, and to revise the law to encourage enforcement and intermediation by giving creditors, including minority shareholders, bond holders and banks, stronger rights.

In the meantime, we note that the regulations by China's central bank and CBRC are moving along the right avenue. For example, in September 2005 CBRC released a provisional guideline on the operations of boards of directors of joint-stock commercial banks, and placed more pressure on independent directors of banks. It appears that bank regulators incline to use a 'process driven' approach to corporate governance, focussing on processes and the achievement of particular targets.

Also, when the government made the capital injections into BOC and CCB early this year, it set several quantitative goals for these two banks to achieve, such as a minimum ROA of 0.6% and ROE of 11%, a maximum NPL ratio within the range of 3%-5%, and different LLR coverage ratios. Such goals should be helpful to reduce moral hazard, later accompanied by capital injection or bailout.

Also, a well-structured financial safety net, such as a deposit insurance scheme and small investor protection fund, is very important for the financial reform of China. Any whiff of doubt about the safety of deposits, especially in the big four commercial banks, could lead to total disaster. In view of the lessons related to the financial safety net in developed countries, China can consider adopting the following features for the deposit insurance scheme to make it more effective and incentive compatible (Zeng, 1997)<sup>9</sup>:

1. to make the insurance deposit scheme explicit, not implicit;
2. to include all banks into the deposit insurance scheme and differentiate them by taking a risk-based premium schedule to distinguish strong banks from weak banks;
3. to reduce the moral hazard of depositors by adopting co-insurance and loss deduction;
4. to reduce the moral hazard of bank management by ordering more closure/bankruptcy liquidation of insolvent banks and implementing more rigorous discipline against the management of failing banks.
5. to strengthen the information disclosure of banks and establish an early warning system of bank crises.

---

<sup>9</sup> Xiasong Zeng, "Deposit Insurance System: Operations, Pitfalls, and Improvements", Securities Market Herald, September 1997.

But the most urgent issues in China's financial reform is to end the financing of under-performing SOEs by banks, terminate intervention from governments in the management and operations of SOEs and banks, recruit and appoint the managements of banks and SOEs by market-based approach, rationalize the incentive structure and improve the corporate governance of companies and banks, and establish a well-structured deposit insurance system. Unless these issues are solved, all else will be built on shifting sands.

## ***References***

Chiu, Becky and Lewis, Mervyn K, 'Reforming China's state-owned enterprises and banks,' Edward Elgar, Cheltenham, 2006, forthcoming

De Soto, Hernando. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. New York: Basic Books, 2000

Garcia, Gillian, *Deposit Insurance: Obtaining the Benefits and Avoiding the Pitfalls*, IMF Working Paper/96/83.S

Garg, Sunil and Zeng, Xiaosong, *China Banks: Bubble Trouble, Oh No, Not Another Bear*, September 5, 2005

Goodhart, Charles. *The Central Bank and the Financial System*, MacMillan, 1995

Goodhart Charles, *The Incentive Structure in Financial Regulation*, 1997

OECD, *Market Discipline Crisis Management and Deposit Protection*, Prudential Supervision in Banking, 1987

Sheng, Andrew, Geng Xiao and Yuan Wang. *Corporate Governance and Property Rights Infrastructure: The experiences of Hong Kong and Lessons for China*, Revised for Chapter 6 in China Conference Volume, "Policy Reform and Chinese Markets: Progress and Challenges", Stanford University Press, 2003

Zeng, Xiaosong, *The constraints and Solution in the Reform of State-owned Enterprises*, Wuhan University Academic Journal (Chinese), October 1995

Zeng, Xiaosong Zeng, *Deposit Insurance System: Operations, Pitfalls, and Improvements*, Securities Market Herald (Chinese), September 1997

Zeng, Xiaosong, *On Information Disclosure and Financial Regulation*, International Financial Studies (Chinese), September 1997

Zeng, Xiaosong, *Executive Stock Option Scheme: Structure, Accounting Recognition, Pitfalls, and Improvements*, Securities Market Herald (Chinese), April 1998

## **China Financial Regulatory and Legal Initiatives Update**

Xiaosong Zeng, CFA<sup>10</sup>

### **Summary**

- 2005 China Financial Forum: We recently attended the 2005 China Financial Forum, “Financial Ecology: Challenges to the Development of China’s Financial Industry”, co-sponsored by the People’s Bank of China and various financial regulatory authorities.
- Criminal law: China is to amend criminal law to broaden the definition of crimes to cover conduct that includes willfully providing false information for loans, as well as making large loans imprudently. This should help lower the incidence of bank frauds.
- Bankruptcy law: China is amending the bankruptcy law to acknowledge claims from creditors by seniority, allow pledging of current assets, stipulate a foreclosure process, and penalize intentional evasion of obligations. A personal bankruptcy law would also be incorporated. This should bring China’s financial system closer to best practices.
- Property rights law: China is drafting a new property rights law to strengthen recognition and protection of property rights (for individuals, companies, and financial institutions). The new law is expected to protect creditors’ claims on collateral.
- Securities law and company law: China’s securities law and company law were amended in Oct-05 (changes effective Jan-06) to strengthen corporate governance, disclosure and accountability.
- Foreign strategic investments: The CBRC disclosed five internal guidelines in reviewing proposals for investment by foreign banks in Chinese banks. China also issued a policy statement permitting foreign “strategic investors” to invest in A shares.

### **New financial legal and regulatory initiatives outlook**

We attended the 2005 China Financial Forum, “Financial Ecology: Challenges to the Development of China’s Financial Industry”, co-sponsored by the People’s Bank of China (PBC, the central bank of China) and all financial regulatory authorities, including China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC), on November 3 in Beijing.

Among others, senior officers of each of the regulators, legislators, and academicians made speeches at the meeting.

#### **Legal initiatives:**

---

<sup>10</sup> Xiaosong Zeng, CFA, is a senior analyst with a global investment bank. This paper reflects entirely the author’s personal views and does not represent the views of any other entity, company, or institution. The author is grateful to Professor Charles Goodhart and Mr. Sunil Garg for their comments on this note.

- China is considering the amendment of the Criminal Law to broaden the definition of criminal offenses to cover conduct such as willfully providing false information to lenders for loans, as well as making large loans imprudently.
- China's national congress is in the process of amending the Bankruptcy Law to acknowledge claims from creditors (both domestic and foreign) by seniority, permit the pledging of current assets (such as inventory and account receivables) by debtors, stipulate the foreclosure process, and penalize debtors who intentionally evade repayment obligations. The amendments would also incorporate a personal bankruptcy law.
- China's national congress is drafting a new law, Property Rights Law, to strengthen the recognition and protection of property rights of individuals, companies, and financial institutions in China. The new law is also expected to protect the claims on collateral by secured creditors.

### **Implications: Positive for lending institutions**

To define the willfully provision of false information to lenders for loans as a criminal offense should be helpful to deter loan frauds, which have been afflicting China banks for decades.

As reported by the official Xinhua news agency in October 2005, China uncovered 240 cases of corruption in its state-owned banks in 1H05, with losses totaling RMB1.6 billion yuan (US\$198 million), as per an officer of CBRC.

The CBRC officer also said that the large number of bank scandals was attributed to the restructuring and reforms implemented in China's banks and the improvement of the government's efforts to crack down financial crimes.

We believe that the proposed amendments to China's Bankruptcy Law and the enactment of Property Rights Law, as well as the newly amended corporate law (to be analyzed in the later part of this note), would be fundamentally beneficial for all banks (including HK-listed CCB and BoComm) and other lending institutions, whose NPLs were highly associated with China's fuzzy and debtor-friendly Bankruptcy Law.

On the other hand, no matter how the laws are enacted or amended, the enforcement of regulations and laws in China have been inadequate, and internal control and risk management of China's banks remain lax. Investors should always consider building the fraud risk into the valuation model.

CBRC's latest data of non-performing loans (NPLs) indicate that as of September 30, 2005, the total NPL balance of commercial banks in China is RMB1,280.83 billion, accounting for 8.58% of aggregate loan balance. The NPL balance declined by 13 bps Q/Q and 479 bps Y/Y, and the NPL ratio improved from 8.71% in 2Q05 and 13.37% in 3Q04.

**Table 1: NPLs of China's major commercial banks, 3Q04–3Q05**

Rmb in billion

	3Q04		4Q04		1Q05		2Q05		3Q05		Growth of NPL ratio (percentage points)	
	balance	Percentage in gross loans (%)	balance	Percentage in gross loans (%)	balance	Percentage in gross loans (%)	balance	Percentage in gross loans (%)	balance	Percentage in gross loans (%)	Y/Y	Q/Q
<b>NPLs</b>	1,699.8	13.37	1,717.6	13.21	1,827.5	12.40	1,275.9	8.71	1,280.8	8.58	(4.79)	(0.13)
Substandard	322.6	2.54	307.5	2.36	341.0	2.30	409.3	2.79	750.8	2.65	0.11	(0.14)
Doubtful	861.9	6.78	889.9	6.84	935.3	6.30	493.0	3.37	511.1	3.42	(3.36)	0.05
Loss	515.3	4.05	520.2	4.00	551.1	3.70	373.6	2.55	374.2	2.51	(1.54)	(0.04)
<b>NPLs by Lenders</b>												
Large commercial banks	1,699.8	n.a.	1,717.6	n.a.	1,712.8	12.70	1,163.7	8.79	1,170.7	8.70	n.a.	(0.09)
State-owned banks	1,559.6	15.71	1,575.1	15.57	1,567.1	15.00	1,013.5	10.12	1,017.5	10.11	(5.60)	(0.01)
Joint-stock banks	140.2	5.03	142.5	4.94	145.8	4.90	150.3	4.66	153.2	4.51	(0.52)	(0.15)
City commercial banks	n.a.	n.a.	n.a.	n.a.	107.4	11.50	103.9	10.43	102.7	9.74	n.a.	(0.69)
Rural credit union	n.a.	n.a.	n.a.	n.a.	3.6	6.10	4.5	6.38	4.2	5.80	n.a.	(0.58)
Foreign banks	n.a.	n.a.	n.a.	n.a.	3.6	1.20	3.8	1.14	3.2	0.92	n.a.	(0.22)

Source: CBRC and our calculations based on CBRC data.

CBRC did not indicate whether the NPL data above exclude Industrial & Commercial Bank of China (ICBC)'s transfer of roughly Rmb705 billion NPLs to state-owned asset management companies (AMCs) in 1H05, but we suspect that may be the case. If Rmb705 billion is added to the NPL balance, the industry-wide NPL ratio at the end of 3Q05 would be 13.0%, not significantly lower than the ratio a year ago.

The amended bankruptcy law is also expected to stipulate the bankruptcy of individuals, and such stipulation should help the development of credit card and other consumer banking businesses in China.

### To establish the Deposit Insurance Scheme

Regulators called for establishment of Deposit Insurance Scheme (DIS) in China to build a safety net for depositors.

### Implications: remains to be seen for China banks

We believe that China will launch the DIS soon. PBC is working with the Ministry of Finance, CBRC, Legal Office of the State Council, and National Development & Reform Commission (NDRC) to draft the deposit insurance directives. Consensus on the scheme was reached on the following:

To set up a DIS, mandatory for all domestic deposit taking financial institutions (it is yet to be decided whether foreign banks are included in the scheme).

Funding for the DIS would include initial capital from PBC, insurance premiums from insured deposit taking financial institutions, as well as the surplus in liquidating insolvent institutions.

Major issues that remain to be addressed in the directive include:

- How much is the coverage limit - Rmb100,000 or Rmb200,000. PBC's survey in April 2005 indicated that bank accounts with deposit balances over Rmb100,000 accounted for 98.3% of all bank accounts in China). If the Coverage is increased to Rmb200,000, the number of insured depositors will increase to 99.3%.



- Should the insurance premium be the same or different for deposit loss in different ranges.
- Affiliation of the deposit insurance company - PBC, CBRC, or other government authority.
- DIS creates stability in banking systems and are hence positive from that perspective. However, it is also worth noting the negative impact from: (a) higher costs for banks, particularly if participation is mandatory and there is no differentiation between banks; and (b) creating moral hazard, unless regulators take a more pro-active approach in closing insolvent banks (which is being considered by China's financial regulators).

## **Nationwide credit information system**

Government officers urged to expedite the establishment of a nationwide credit information system in China to facilitate the sharing of credit information of both companies and individuals.

### **Implications: Positive for consumer banking business**

Currently, there are two standalone credit bureaus (one in Shanghai and one in Shenzhen) and PBC has set up a department to coordinate the establishment of a nationwide credit information system in China. A nationwide credit information system may initially cover financial transactions only, while the two standalone credit bureaus (which are expected to remain in place) have a wider scope, covering all payment records (including utilities payments).

A nationwide credit information system would reduce the information asymmetry between lenders and debtors in China and help the credit risk management of banks' corporate and consumer financing business. Banks' credit card and residential mortgage business is expected to immediately benefit from the nationwide system.

There were 827 million bank cards issued in China as of March 2005 (+19.6% Y/Y), while credit cards account for a small proportion (33 million cards out of 827 million bank cards) but are witnessing rapid growth.

**Table 2: Credit card balance in China (as of 31 March 2005)**

Credit balance of credit cards (in Rmb million)	9,367
% in residents total consumer loans	0.45%
Average credit balance per credit card (in RMB)	283

Source: Our estimates based on data from China Union Pay.

There are an estimated 500,000 merchants in China accepting credit cards and annual transactions aggregate Rmb2.5 trillion (over \$300 billion).

**Table 3: Market share and ranking (by total transaction amounts of all cards issued) as of 31 March 2005**

Rank	Bank	Market share (%)
1	ICBC	25.38
2	ABC	22.95
3	CCB	15.85
4	BOC	11.72
5	CMB	8.20
6	BoComm	4.48
	All others	11.42
<b>Total</b>		<b>100.00</b>

Source: China Union Pay.

**Table 4: Rank of major PRC banks by total credit card balance (as of 31 March 2005)**

Rank	Bank
1	ICBC
2	ABC
3	BOC
4	CMB
5	Guangdong Dev Bank
6	CCB
7	Bank of Shanghai
8	CITIC Industrial Bank
9	Shenzhen Dev Bank
10	BoComm
11	Industrial Bank
12	Everbright Bank
13	Shanghai Pudong Development Bank

Source: China Union Pay.

A market survey conducted by McKinsey in October 2005 reports that, currently the credit card industry as a whole in China is experiencing losses, without profit from 50% of customers, and only 14% of customers in China use the revolving credit line vs. over 50% in the US. However, the McKinsey forecasted that the market to grow exponentially and the credit card industry is forecast to be profitable in three years, with total projected profit reaching RMB13 - 14 billion in 2013, and retail credit business is forecast to account for 14% of profits for the banking industry.

### **Rules on NPL collection and the operations of financial AMCs to be amended to make the latter more efficient**

#### **Implications: Positive.**

AMCs were established by the government to take over the legacy NPLs from large state-owned banks thus facilitating their IPOs. The operating rules of AMCs should be more clearly defined and the transparency of AMC operations needs improvement, in our view.

So far, the four AMCs have processed NPLs of Rmb736.7 billion and collected cash of Rmb155.0 billion, with a cash recovery ratio of 21.04%. Specifically:

**Table 5: NPLs processed by AMCs and cash recovery ratio**

Rmb in billions except %

AMCs	NPLs Processed	Cash Recovered	Cash Recovery
Huarong	223.8	45.52	20.34%
Great Wall	235.03	24.77	10.54%
Oriental	113.47	27.77	24.47%
Cinda	164.36	56.97	34.66%
<b>Total</b>	<b>736.66</b>	<b>155.03</b>	<b>21.04%</b>

Source: CBRC.

But the NPLs collected so far are usually the best quality NPLs however.

A more pro-active approach in closing insolvent banks and securities' firms and holding accountable senior management of failing financial institutions for mismanagement.

#### **Implications: Positive.**

More closures instead of government bailouts of failing financial institutions can help reduce moral hazard.

#### **Encouragement of well-managed financial institutions to develop financial derivative products**

#### **Implications: Neutral.**

Financial derivative products can help China banks expand and diversify revenue sources, but conducting financial derivatives business without the support of a sound risk management system could be highly risky for banks.

#### **Reducing China companies' dependence on bank loans and encouraging direct financing, particularly corporate bonds and money market instruments**

PBC data indicated that around 80% of the funding of China companies is from bank loans, with high systematic risk to banks.

#### **Implications: Remains to be seen.**

PBC has tried to convince other governmental authorities (primarily China's National Development & Reform Commission, or NDRC) controlling the approval of corporate bond issuance to ease controls over the last few years. An easing of the control and a transition to a market-orient debt market can reduce the credit risk of China's banks and help them generate more fee income, which is less capital consuming than loans.

#### **Reduction of insurance companies' asset concentration in banks**

CIRC data indicated that bank deposits still account for a large proportion of China insurance companies' total investments (38.2% of the RMB1,307.1 billion total investments as of Sept. 30, 2005), compared with 51.2% in bonds, 8.1% in mutual funds, 0.8% in equities, and 1.7% in others. Also, banks in aggregate hold roughly 95% of China's financial assets, while insurance companies account for only 3%, which is very low compared with developed markets.

**Implications: Positive.**

Less dependence on bank deposits can help improve the profitability of insurance companies.

9. To encourage the development of insurance industry in China and approve more private and foreign insurance companies to start business.

**Implications: Negative for insurance companies.**

More insurance companies entering into China's insurance market will heighten the competition and pressurize pricing further.

### **Recent Amendments to China's Securities Law and Company Law**

On October 27, China's national congress approved the amendments to the Securities Law and company law, and the amendments will take effect Jan. 1, 2006.

The amendments are substantial and we expect that the amendment laws will bring significant changes to China's banks, listed companies, and the securities market.

**Amendments to China's Securities Law**

The amendments to China's Securities Law set the following new rules (among others), which we believe are generally positive for shareholders of listed banks:

- Issuers and listed companies should pay damage to investors if the information disclosures contain misrepresentation, misleading statements, or material omissions. Directors, members of the supervisory board, and senior management of the listed companies, as well as the underwriter of the securities should also be legally liable for the faulty disclosure, unless they can be acquitted. Controlling shareholders associated with the faulty disclosure should also pay damage to other investors.
- The amendment deletes the clause prohibiting state-owned companies or companies with majority ownership by the state from investing in stocks of listed companies.
- The amended law reiterates the separation of securities, banking, trust, and insurance businesses, but provides for an exception: "unless otherwise decided by the state government".

**Implications: Positive.**

The amended Securities Law puts more legal liabilities on corporate insiders and securities underwriters making faulty disclosure, and protects the interest of equity and bond investors further.

The amended Securities Law also strengthens investor protection by stipulating rules on setting up the securities investor protection fund and requiring investors' funds to be held at commercial banks.

In September 2005, China set up a securities investor protection fund with registered capital of RMB6.3 billion.

The amendments also enable the state to buy back shares of listed companies and banks. China Construction Bank (CCB) is 71.1% by Central Huijin (which is also known as “China SAFE Investments Ltd.”), which is wholly owned by the state government. Similarly, Bank of Communications (BoComm) is 22.2% owned by the state government (Ministry of Finance) and 6.7 % by Central Huijin.

The exception on the separation of securities, banking, trust, and insurance business lays the ground for cross-industry operations within the financial sector in China, which has thus far been subject to a strict rule prohibiting the business crossing between banks, securities firms, and insurance companies. This is a critical part of reforms leading to revenue diversification of financial institutions in China.

### **Amendments to China’s company law**

The amended law reduces the minimum registered capital required for setting up a company, permits the incorporation of one-man companies, increases the liabilities of controlling shareholders, board members, and senior management, and strengthens the protection of small shareholders. Specifically:

- If the directors of the board and/or the senior management of a listed company hurt the interests of the company or other shareholders, they will have to pay damages to the company. Victimized shareholders will be able to sue the controlling shareholders and the senior management of the listed company for damages.
- The amendments stipulate that if the controlling shareholders of corporations or LLCs willfully assist companies under their control to evade repayment obligations or illegally seize assets from indebted companies with higher seniority, the controlling shareholders will have unlimited liabilities on the debts of companies under their control.
- If a listed company has not paid dividends for consecutive five or more years while it is profitable during these prior five or more years (the law prohibits companies from paying dividends under certain circumstance), shareholders can request the company to buy back their equity at reasonable price.
- Companies can buy back no more than 5% of outstanding shares with net income to reward employees, and the stocks should be awarded to employees within one year from the repurchase day.

### **Implications: Positive for China banks.**

We believe the new rule on controlling shareholders’ liability facilitates class actions in China and overseas against China's listed companies.

Also, it is common in China for controlling shareholders to seize the assets of bankrupt subsidiaries before the creditor banks have been paid. The amendment can help the foreclosure and liquidation actions taken by banks against defaulting borrowers.

Shareholders of China banks can also press banks to pay dividends and buy back stocks to reward the management to align their interest with shareholders.

In conclusion, we believe the amendments to China's Securities Law and company law help improve the corporate governance of listed China banks and companies, strengthen the protection of investor interest, and protect banks from the illegal seizing of debtors' assets by controlling shareholders.

## **Rules on Foreign investments into China banks**

### **CBRC's internal guidelines on reviewing foreign investments in banks**

China's banking regulation currently limits foreign investment in Chinese banks to less than 20% for a single investor and less than 25% for all foreign shareholders.

After discussing the subject with a CBRC officer on this policy in October, we believe that CBRC is working to raise the limit, probably in a phased manner, i.e. first by raising the foreign investment cap for smaller banks, such as Guangdong Development Bank and Huaxia Bank, followed by similar relaxation for the larger banks in later phase(s). Though a specific time line was not provided, we believe that this policy may be revised soon.

On November 2, Mr. Tang Shuangning, CBRC's vice chairman, stated the regulator's preference for long-term strategic investors and released CBRC's five internal guidelines in reviewing the proposal for investment by foreign banks into China banks, as reported by the official Shanghai Securities Journal:

1. Foreign strategic investors can invest in no more than two China banks with similar business model.
2. The minimum investment should not be less than 5% of the China bank's equity.
3. The lock-up period of foreign investment should be at least three years.
4. Strategic investors should participate into the board of directors of the invested bank.
5. Strategic investors should transfer advanced technologies and skills in areas including product development, marketing, and risk management, to the invested bank. And China banks should give priority to foreign investors with transferable technologies and complementary business. And foreign investors should use their international business network to help the invested bank conduct business internationally.

### **Implications: Positive.**

Regulator's internal guidelines above reveal that the Chinese government focuses more on the management, product expertise, and international franchise than the capital alone from foreign strategic investors, and discourages scattering investments in more than two banks in China.

We believe that after foreign banks have more control of the management of invested banks, their strategic investment and the expertise can help China banks improve performance, in view of the business success of foreign banks in China.

CBRC's statistics revealed that, as of September 30, 2005, the NPL ratio was 0.57% and Pre-provision Operating Profit (PPOP) growth was 72% for foreign banks in Shanghai. As a contrast, the NPL ratio of China banks in Shanghai was 3.49%, and the PPOP growth was 17%.

Nationwide, the aggregate NPL ratio of foreign banks in China is less than 1%, and most foreign banks are making profits in China, as per the chairman of CBRC on October 14, 2005.

A survey of 35 foreign banks in China (such as Citibank, HSBC, BNP Paribas, Deutsche Bank, etc.) in October by PriceWaterhouse indicated that, 85% of these banks forecast earnings growth in 2005 and the next three years, over 70% banks forecast earnings growth to be at least 30%, and 17% (six banks) forecast earnings growth of over 100% during the same period.

The consensus of surveyed banks is that the most important business areas are, respectively, credit card, home mortgage loans, and investment products for retail banking, and debt capital market products, credit derivatives/structured products, and risk management products for wholesales banking business.

We are particularly interested in the regulator's encouragement to foreign investors for participation in the invested bank's board of directors, which could help the restructuring of invested banks more rapidly. So far, foreign investors are usually offered only one or two seats on boards with more than 10 members.

These guidelines may offer some clues to the recent reported rejection of Temasek's proposal for investment of US\$3.1 billion in Bank of China (BOC) (for a 10% stake) by the board of BOC's largest shareholder, Central Huijin, due to concern over Temasek's control of more than two China banks (as Temasek is currently the shareholder of CCB and China Minsheng Banking Corp). The proposal of Temasek's investment may be amended and re-submitted for approval however.

### **Foreign strategic investors permitted to invest in A-shares**

On 6 November, CSRC, together with China's Department of Commerce, announced a policy permitting foreign "strategic investors" to invest in A shares of China's listed companies, subject to a lock-in period (not specified in the policy) and as long as the listed companies had completed the conversion of non-tradable legal-entity shares into tradable shares.

The new rule also stipulates that China's listed companies with 25 percent or more of shares held by a strategic foreign investor will enjoy the same special treatment given to Sino-foreign joint ventures. And if a strategic investor sells some of its shares after a lock-up period expires, the Chinese company can still continue to enjoy Sino-foreign joint venture status if the foreign-held stake remains at or above 25 percent.

### **Implications: Positive.**

So far virtually all foreign strategic investments into the A-share banks are in legal-entity shares instead of A shares, so existing A share investors of China's listed banks may be benefited from this policy.



**Table 6: Summary of foreign investments into PRC banks**

<b>Big 5 Banks</b>	<b>Foreign Investor</b>	<b>Stake</b>	<b>Amount Invested (US\$ MM)</b>	<b>Note</b>
ICBC	GS/Allianz/AmEx	10.0%	3,000	Pending for regulatory approval
BOC	RBS, Merrill Lynch, and KS Lee	10.0%	3,100	Being reviewed by Central Huijin
	Temasek	10.0%	3,100	
	UBS	1.6%	500	
	ADB	0.3%	75	
CCB	BofA	9.0%	3,000	Option to increase to 20%
	Temasek	5.0%	1,000	
ABC		0.0%		
BoComm	HSBC	19.9%	2,100	Option to increase to 40%
<b>Joint-stock Banks</b>	<b>Foreign Partner</b>	<b>Stake</b>	<b>Amount Invested (US\$ MM)</b>	<b>Note</b>
China Merchants Bank		0.0%		
SPDB	Citibank	4.6%		Plan to increase to 20%
SZDB	Newbridge	17.9%	145	Pending for regulatory approval
	GE	7.0%	100	
Huaxia Bank	Deutsche Bank, Sal Oppenheim Jr.	13.98%	321	Pending for regulatory approval
	Pangea Group	6.88%	125	
China Minsheng Bank	Temasek	4.6%		
	IFC	1.1%		
China Industrial Bank (Fujian)	Hang Seng Bank	16.0%	200	
	GIC	5.0%		
	IFC	4.0%		
Bohai Bank	Standard Chartered	19.9%	123	
<b>City Commercial Banks</b>	<b>Foreign Partner</b>	<b>Stake</b>	<b>Amount Invested (US\$ MM)</b>	<b>Note</b>
Everbright Bank	Everbright Group	21.4%		HK-based China conglomerate
	ADB	3.0%		
Bank of Shanghai	HSBC	8.0%		HK-based commercial bank
	IFC	7.0%		
	Shanghai Commercial Bank	3.0%		
Nanjing City Commercial Bank	BNP Paribas	19.2%	100	
	IFC	5.0%		
Xi'an City Commercial Bank	IFC	1.0%		
	Nova Scotia	1.0%		
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	20%	78	
Jinan City Commercial Bk	Commonwealth Bank of Australia	11%		
Bank of Beijing	ING	20%	215	
Guangdong Development Bank	DBS and/or other investors			Being negotiated
Nanchong City Commercial Bank	DEG	10%	3	(in Euro MM)
	SIDT	3%	1	(in Euro MM)
Shanghai Rural Credit Co-op	ANZ	20%		
<b>Total</b>			<b>17,287</b>	

Source: Companies

