



Financial Reform in China: what next?

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Frenzy as ICBC sets out its stall for shares offer

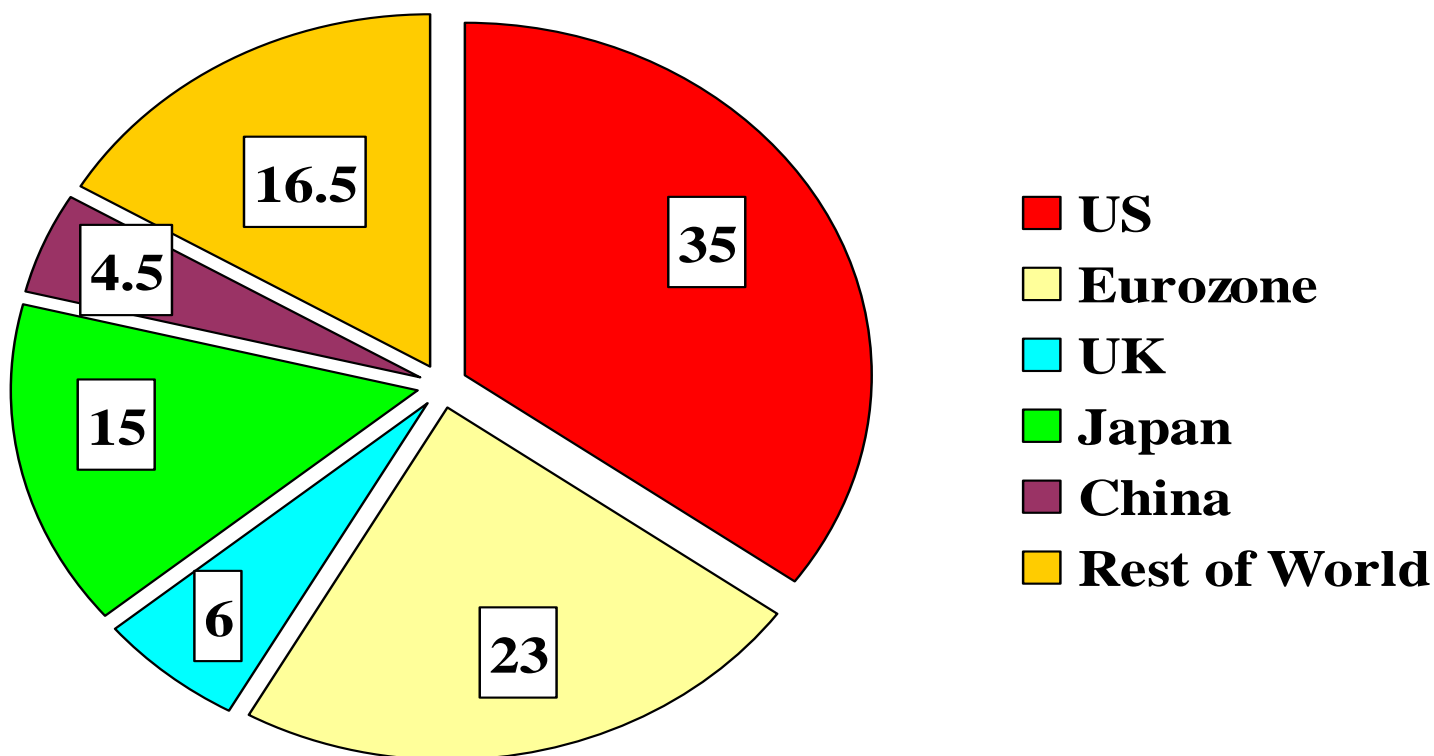
By Tom Mitchel in Hong Kong

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.

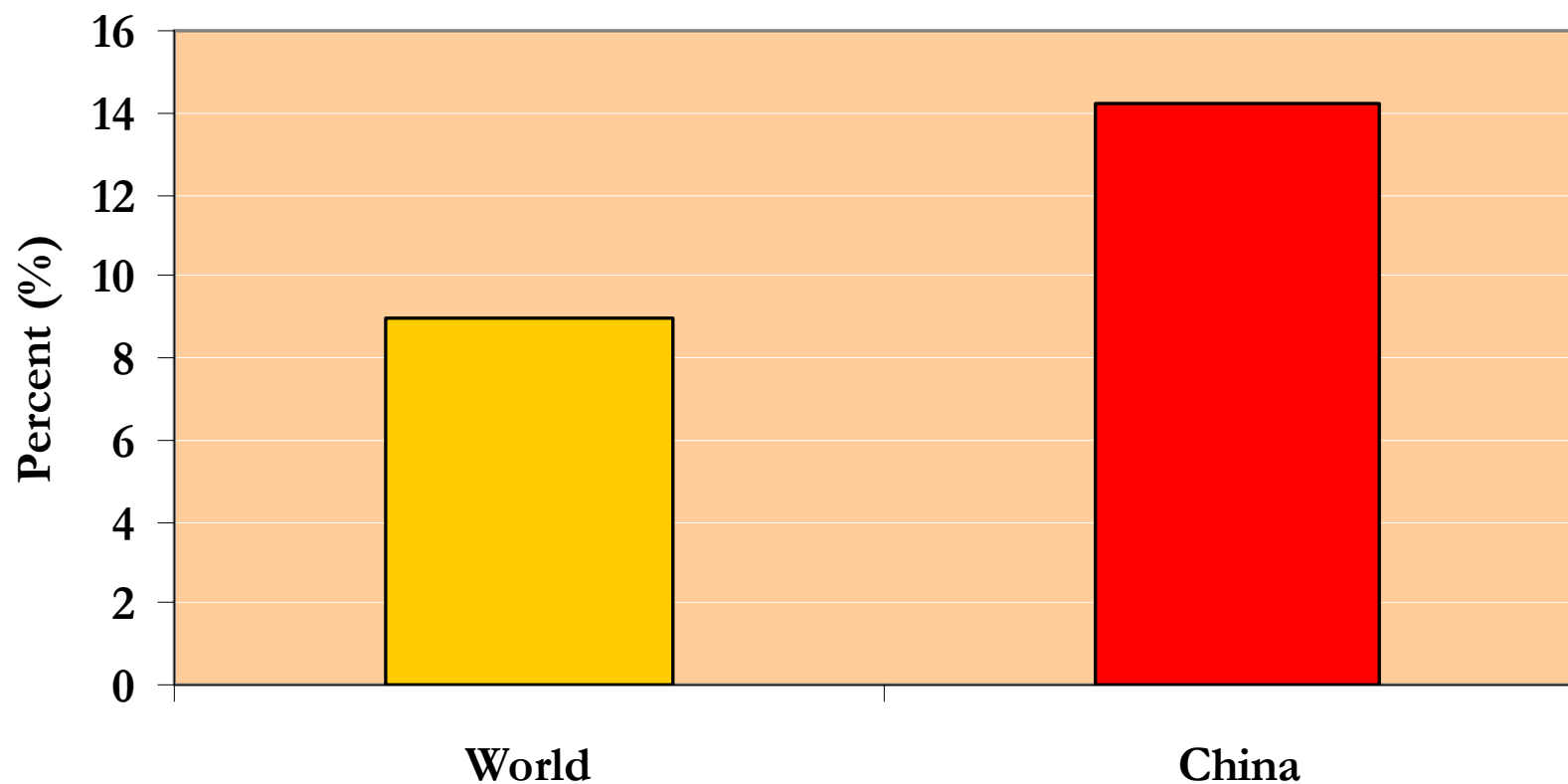
Global Financial Stock 2004 (%)

China is becoming a significant part of the global system



Source: McKinsey Global Institute, 2006

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

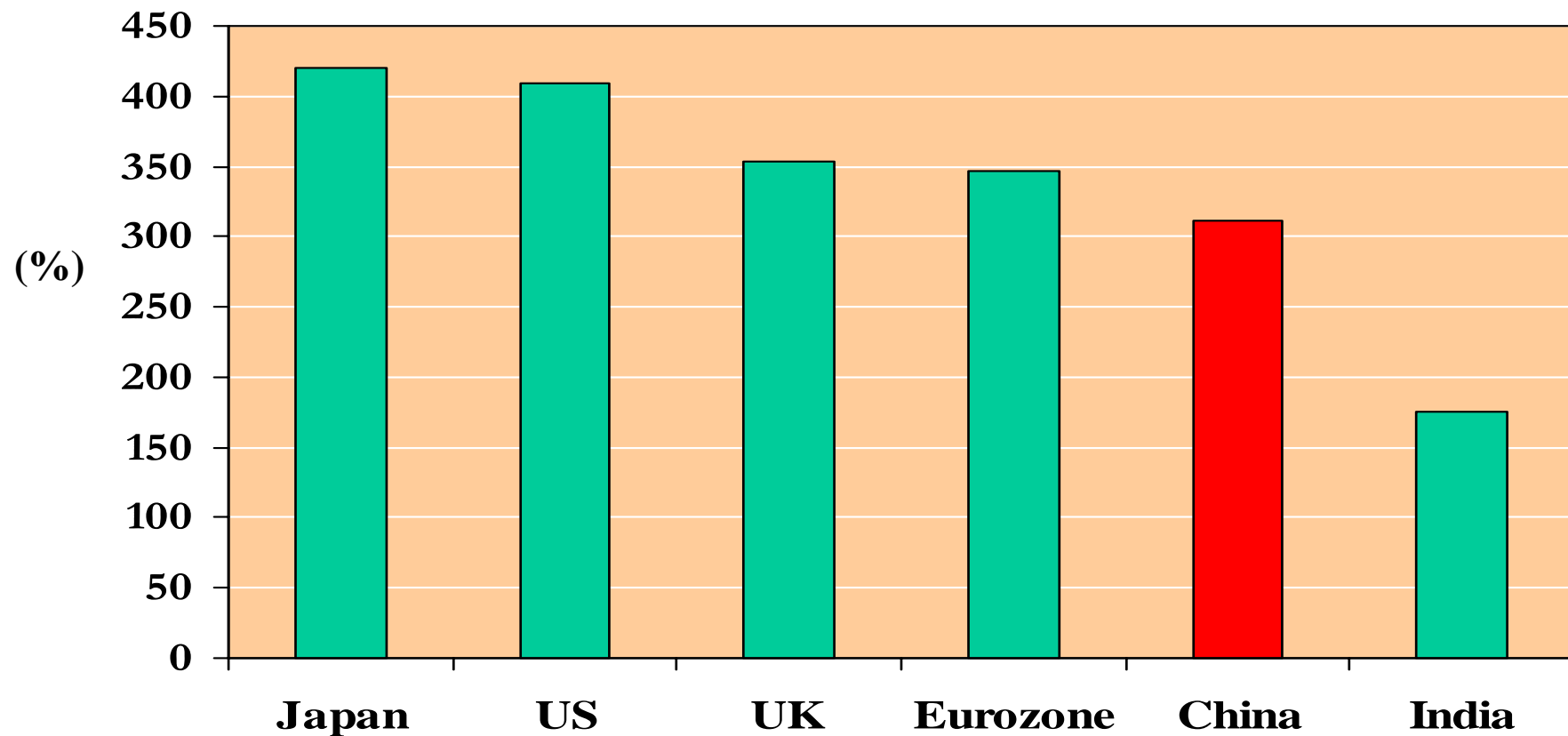


Source: McKinsey Global Institute, 2006

Financial Depth – Financial Stock as % of GDP 2004



China's financial system is already well-developed

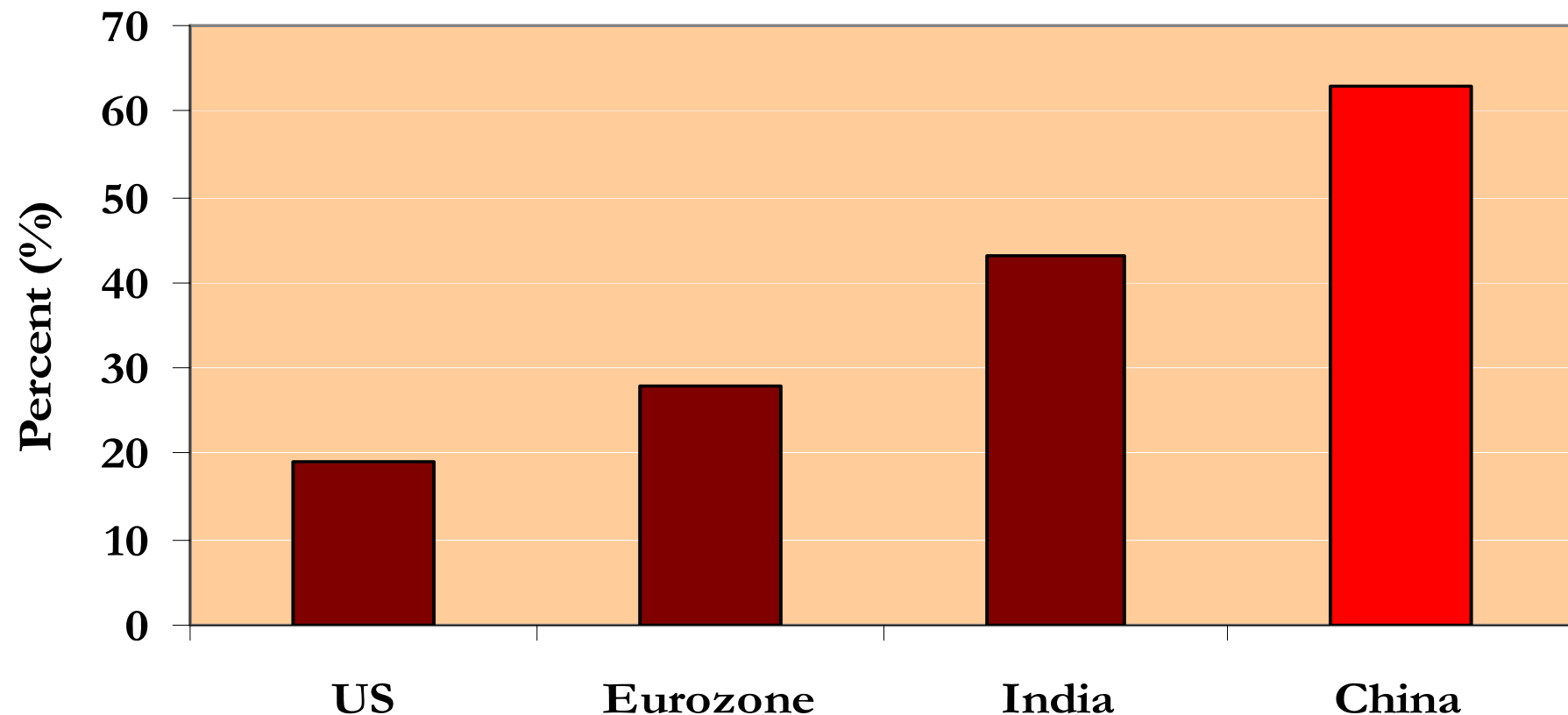


Source: McKinsey Global Institute, 2006

Bank Deposits as % of Financial Stock



But it is very heavily dependent on banks

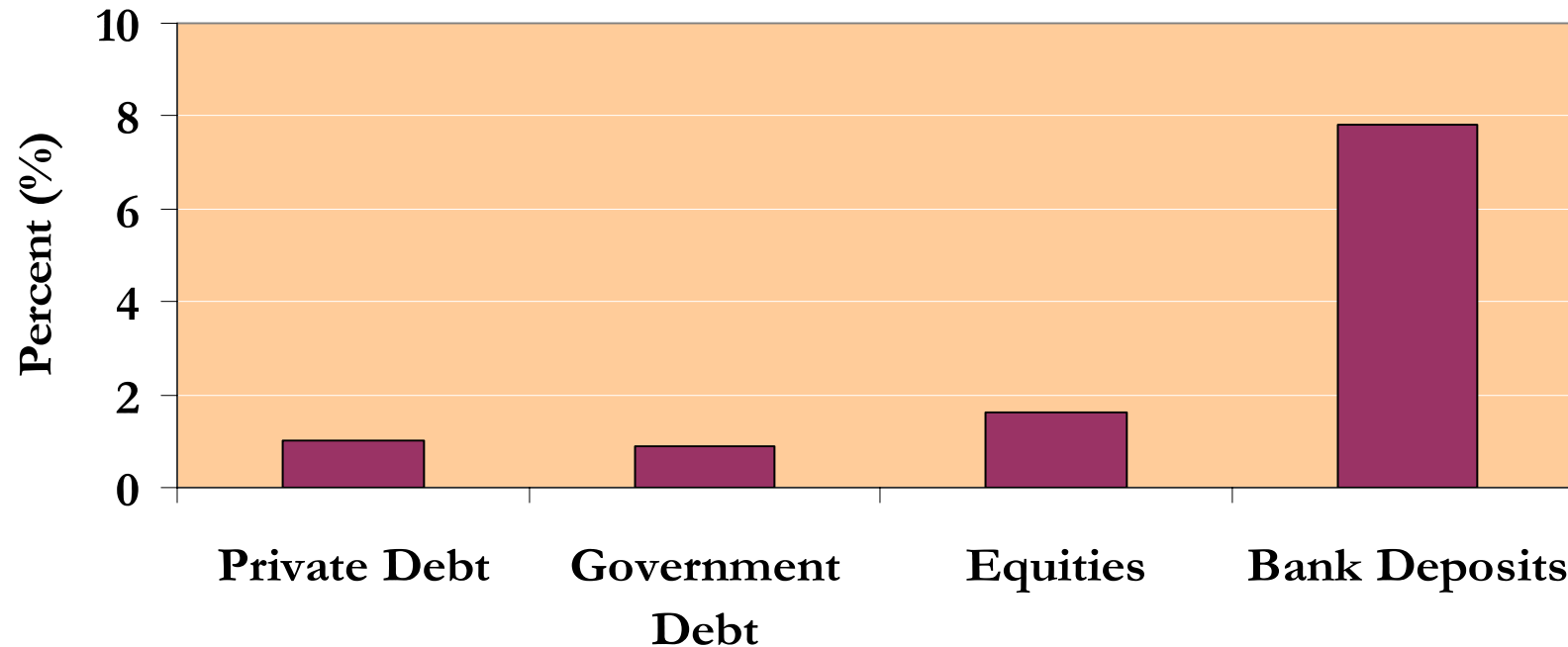


Source: McKinsey Global Institute, 2006

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

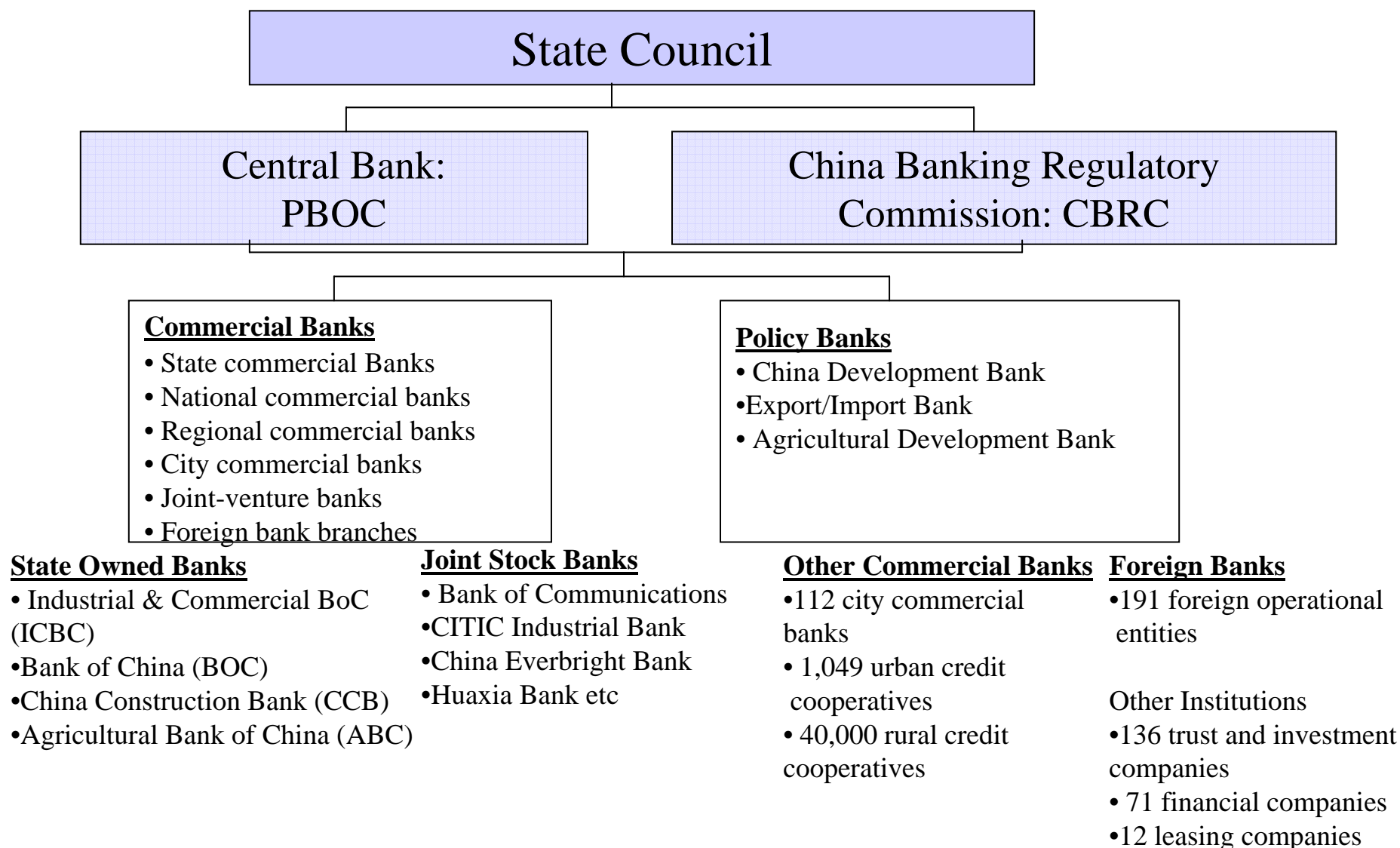


And the capital markets are relatively small



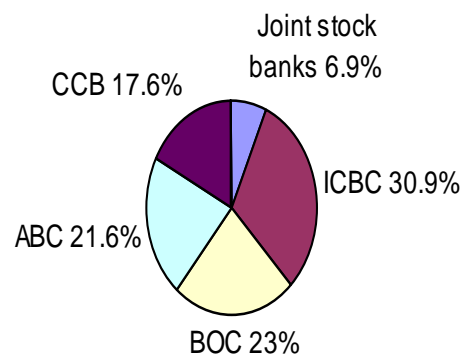
Source: McKinsey Global Institute, 2006

China's Banking Industry Structure

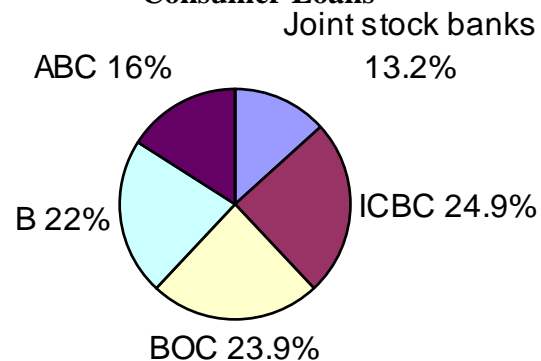


A Market dominated by the “Big Four”

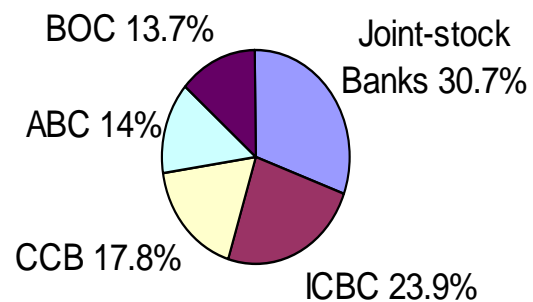
Consumer Deposits



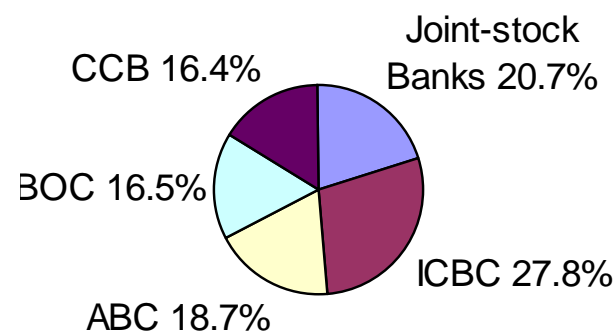
Consumer Loans



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

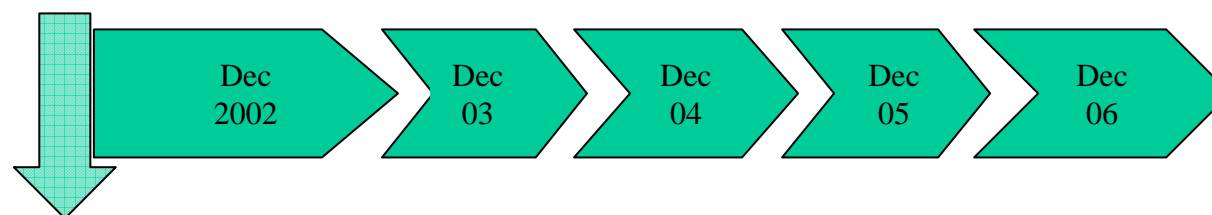
Chinese Bank IPOs

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)



*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,
Shanghai,
Dalian,
Tianjin

Guangzhou, Jinan
Qingdao, Fuzhou,
Nanjing, Chengdu,
Wuhan Chongqing

Kunming,
Zhuhai,
Beijing,
Xiamen

Shantou,
Ningbo,
Shenyang,
Xian

No more
geographic
restriction

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-Term Debt		Financial Strength	
	Long-term		Short-term					
	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+

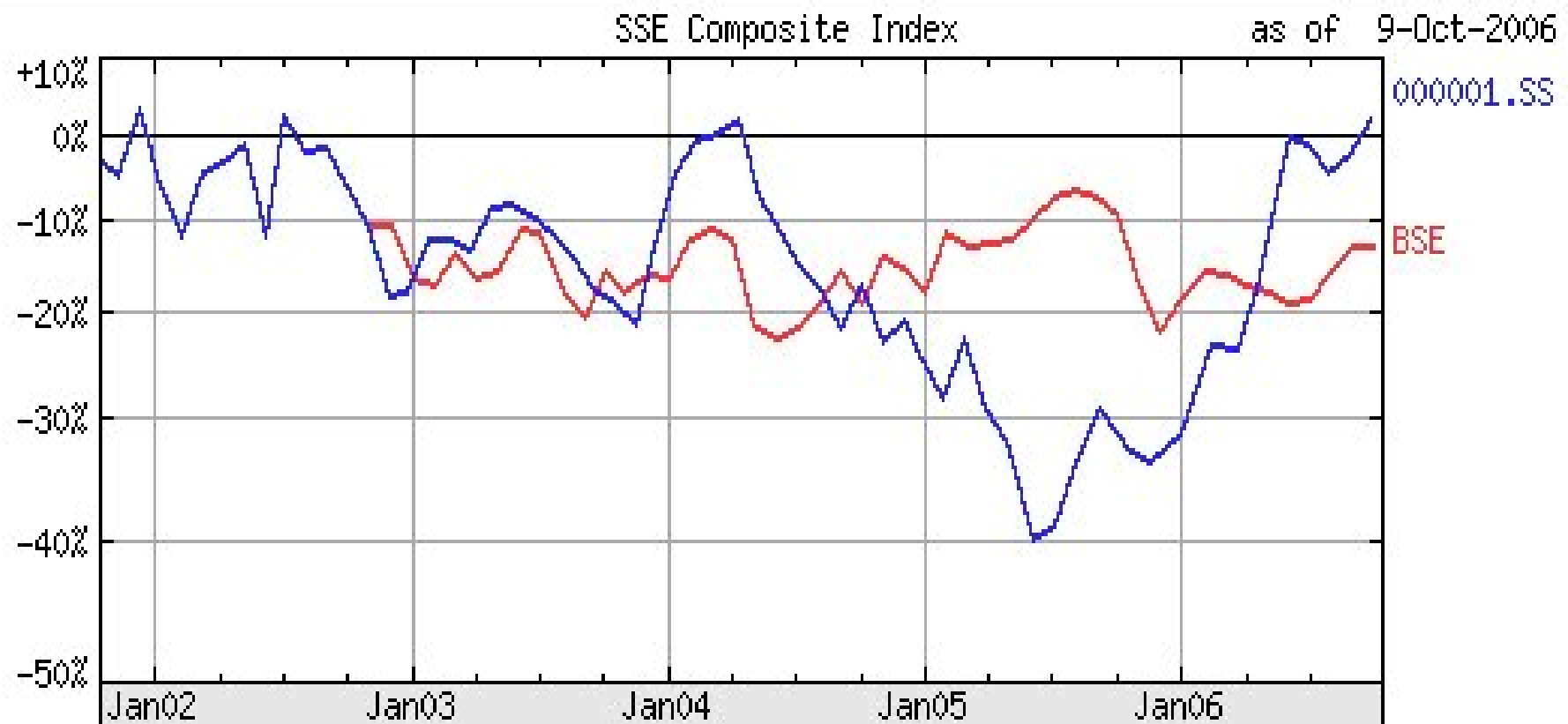
Key Challenges for Chinese Financial System

- 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

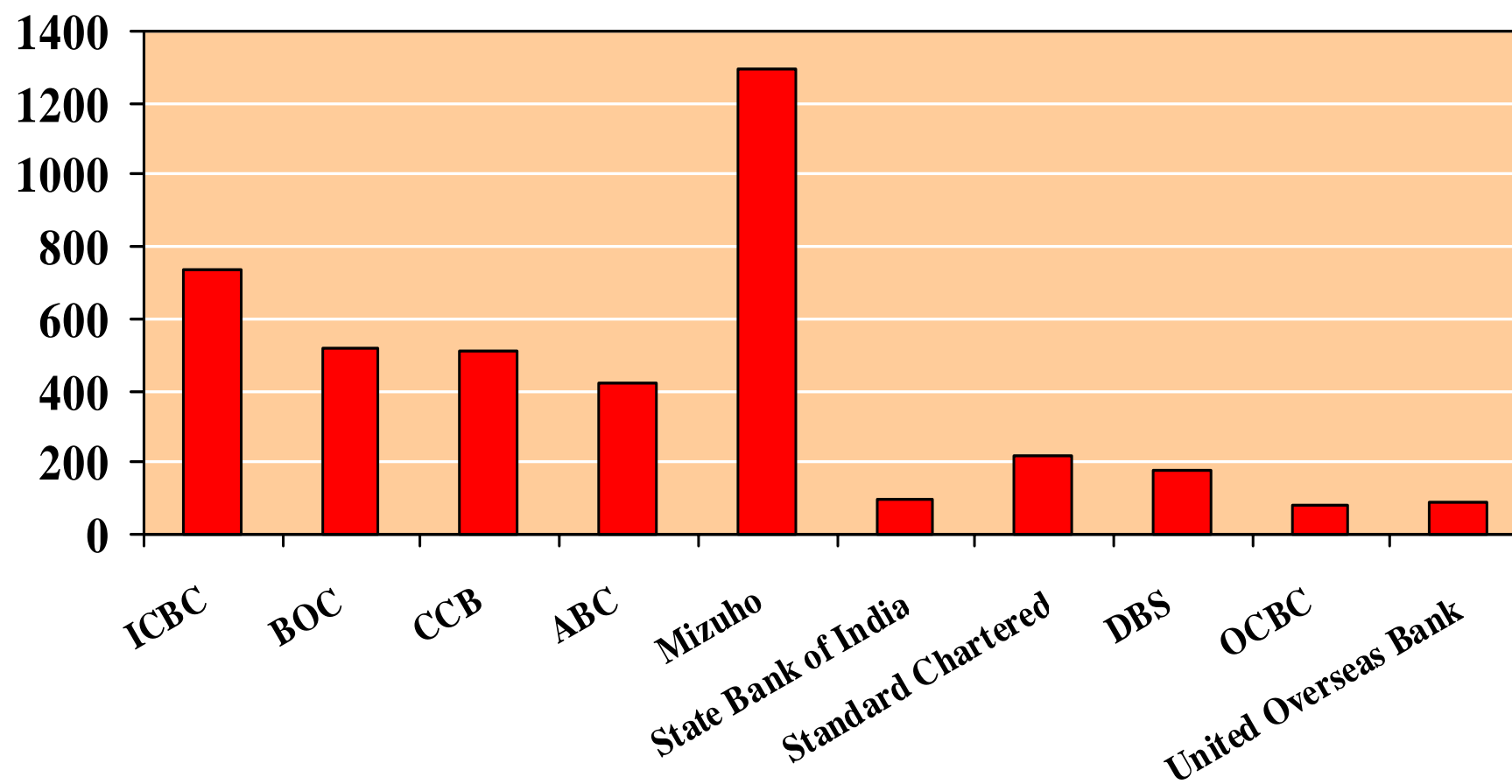
Regulatory Reform

- 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)





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