Financial Reform in China: what next?– Hong Kong Theatre, LSE

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This is the third in the series of lectures I have given in the School on the progress of financial reform in China. (Slide 1) I have watched the process for over a decade, since I was Deputy Governor for the Bank of England, and for three years have been on the International Advisory Councils of both the CBRC, the banking regulator, and the CSRC, the securities regulator. But I should emphasise that what follows is a personal view, and in no way reflects the opinions of the Chinese Commissions. It has been a privilege to work with Chairman Liu Ming Kang and Chairman Shang Fu Lin, and I have enormous admiration for their achievements. They would not be surprised, however, to learn that I believe there is still more to do.

Frenzy in Hong Kong

Now is a good moment, as the latest Chinese bank IPO, for the Industrial and Commercial Bank of China, is about to be launched in Hong Kong, to reflect on how far the Chinese system has now been reformed. Today's Financial Times reports that the demand for ICBC shares is likely to outstrip all estimates, under the headline "frenzy as ICBC sets out its stall for shares offer". (Slide 2) Last week the Economist offered a view on why there is such enthusiasm. They argued "ICBC is a proxy for China itself: vast, diverse, growing fast, and with extraordinary scope for internal restructuring". Though ICBC's number of branches has fallen from 42,000 at its peak to 18,000, there is still more scope for cost cutting for and re-structuring. It certainly looks as though the earlier investors in ICBC, such as Goldman Sachs, will make a sizeable return on their investment. Goldman Sachs bough 5.8% of the bank for $2.6 billion, and may well triple their investment on paper, after the float. (They are required to hold their shares for a period of years).

But the Economist added "ICBC also reflects the murkier side of life in the Chinese economy. Political considerations often come first, information is unreliable, and openness in the banking system is questionable, despite WTO entry". They point out that only two years ago 27% of ICBC's loans were non-performing, and even after capital injections the figure is probably 5%, 5 times what would be considered acceptable in a British or American Bank. But the Economist adds that these sceptical voices "will barely be heard amongst the deafening clamour for shares".

Should the sceptical voices listened to? How soundly based are these new banks being brought to the market.

Global Comparisons

To answer these questions we should begin, first, by looking at the scale of China's financial system in the global context.

China is now becoming a significant part of the global system (slide 3). The McKinsey Global Institute publishes rather "by and large" figures for the global financial stock, defined as the liabilities of the banking system, plus the capital value of traded bonds and equities. Clearly this figure is somewhat volatile, and moves with the markets, but a snapshot at the end of 2004 shows that China's financial stock is about 4.5% of the world total, by comparison with around 6% in the UK, 15% in Japan and 30% in the US.

This is already a significant percentage, and is growing all the time. The global financial stock is growing at just over 8% a year, while China's financial stock is growing at around 14%, and has done for the last decade or more. (Slide 4)

Another interesting measure which the McKinsey report cites is what they call financial depth, defined as the financial stock as a percentage of GDP. On this measure, China's financial system is already quite well developed (slide 5). Its financial stock is just over 300% of GDP, compared to around 350% in the UK and the Eurozone, while by contrast India's stock is only around 175% of GDP. So China's financial system looks to be relatively sophisticated. But we should be cautious about reaching that conclusion. The Chinese system is very heavily dependent on banks (slide 6).

Over 60% of the Chinese financial stock is in the banking system, compared to less than 20% in the US and just below 30% in the Eurozone. Even India, a country with a significantly lower GDP per head still, has only just over 40% of its financial stock in the form of bank deposits. A 60% ratio is unusual for a county of China's stage of development. Normally, by this time the equity and bond markets would be accounting for a larger proportion of the financing of companies, in particular. The international financial institutions typically recommend that developing countries seek to diversify their funding sources, and to develop healthy bond markets. Otherwise, far too much of the burden of financing development falls on the banking system, and the financial system is thereby more vulnerable. Equity and bond markets provide significant shock absorbers in the event of economic downturns. You do not wish the financial implications of a downturn to be felt entirely by the banks, or for all bad debts and failed investments to end up on the banks' balance sheets. One part of the explanation of the large number of non-performing loans in the past is that companies have been too dependent on bank debt financing.

The other side of the coin, therefore, is that Chinese capital markets are relatively small (slide 7). They account for less than 1% of the capital value of global traded private and government debt (though one should note that the distinction between private and government debt in China is not straightforward). China's equity markets, which have been languishing for sometime, are below 2% of the world total still, while China accounts for over 8% of bank deposits.

So the Chinese financial system is somewhat unbalanced, but their banks are poised to become significant actors on the international stage. I would note, incidentally, that this point has not yet been recognised by the key decision making bodies of the world banking system. The Basel Committee, which sets capital standards for banks around the world, still finds no place for China, while there are 10 European members out of 13. It will be essential, in my view, to bring China into the Basel Committee as Chinese banks begin to play a major role in global capital markets following their re-capitalisation and flotation.

The structure of the Chinese banking industry

On the face of it, the banking industry is quite diverse, and there are a wide range of institutions. Three decades ago, the People's Bank was the banking system. Now, while the People's Bank plays an important monetary policy role, and oversees the banks in other respects, there is a separate regulator in the form of the CBRC. (slide 8). Below these two state entities there are commercial banks and policy banks. I will say little about the policy banks, and focus most of my attention on the commercial banks of different kinds.

As I will come on to show, the big four state owned banks dominate the marketplace, but one should not forget the significance of some other entities. The Bank of Communications is large and growing, and urban and rural credit cooperatives have played a very important role in Chinese economic development in recent years. The rural credit cooperatives finance agricultural development, as one might expect, while the urban credit cooperatives have been a very significant source of finance for the private sector. A fascinating recent book "Back Alley banking" by Kelley Tsai, shows that in the 1990s urban credit cooperatives provided over 70% of the funds flowing to private entrepreneurs, while the state banks concentrated on state owned enterprises. Kelly Tsai argues that the big banks remain "institutionally biased towards lending to state units" and quotes a bank Director saying "it is safer to make a loan to a state unit then to an individual stranger". Given the non-performing loans which have emerged in the state owned enterprise sector, and the vibrancy of China's private sector entrepreneurs, this was a very poor banking judgement to make. But it is certainly an accurate characterisation of the culture of the big four banks in the past. This cultural dimension is an important issue, which I will come on to later.

<u>The big four</u>

But if we look in simply in scale terms, we can see that the market remains dominated by the big four (slide 9). They account for over 90% of consumer deposits and just below 90% of consumer loans. On the corporate side, the big four have about 70% of the deposits and about 80% of corporate loans. In this respect the Chinese system looks rather like the British, Australian or Canadian, heavily dominated by a small group of very large institutions operating in both the retail and commercial sectors.

Perhaps in error, in retrospect at least, these big four banks were described as commercial banks by the Chinese over a decade ago, as they came out of the cocoon of the People's Bank. In fact at that time there were many differences between them and the straightforward commercial banks elsewhere in the world. Their lending decisions were dominated by political considerations, their cost bases were not under their own control, funds flows were typically allocated on a kind of geographical and sectorial formula basis, and they should really have been regarded as channels for funding economic development, rather than as commercial entities seeking to make a profit for their shareholders.

As a result, and given that while Chinese economic growth has been very rapid, there have been many casualties along the way among all the successes, by the turn of the century the Chinese banks were clearly in significant trouble. The scale of non-performing loans on their balance sheets was so large that they could not be said to have a meaningful capital base at all. There are as many estimates as Chinese non-performing loans as there are accountants, and analysts and rating agencies who produce them, but even on the official figures 5 years ago the Chinese banks were not equipped to compete in international markets, where an 8% minimum capital base is required (under the old Basel rules).

Since that time, the authorities, and the management of these banks, have pursued a clear and determined strategy (slide 10). The aim has been, first, to strengthen their balance sheets, second, to introduce strategic shareholders who could strengthen the management and I.T. capacity of the institutions, and also develop joint ventures in specialist areas, and third, they have been looking to bring the banks to market in Hong Kong and Shanghai and perhaps later in London, both to introduce external capital but, more importantly, to aid the process of corporate governance reform. International shareholders are likely to be more active in seeking good governance than Chinese state entities.

In the first area, strengthening balance sheets, the authorities strategy has been a combination of removing the worst loans to asset management companies, what we would often describe as "bad banks", capital injections, the enhancement of recovery rates and, to prevent the balance sheets deteriorating again, restrictions on political lending. Just a word or two about these four strands of policy.

The asset management companies are a rational response to the NPL problem. Those companies can have a single minded in focus on debt recovery, without being concerned about a continuing banking relationship with the SOEs in default. They can also develop expertise in packaging and selling loans to others, and a secondary market in Chinese NPLs has now begun to develop. But this was not enough, and the banks needed new capital. That has been provided. For example, ICBC received a capital injection from the government of $15 billion as an aid to the preparation of its IPO.

The enhancement of recovery rates for non-performing loans is not straightforward. (Slide 11) It gets in to the question of property rights in China. When an SEO is unable to repay its debts, what happens to the assets, including the land which may well be valuable. In some cases the assets have reverted to municipal or provincial governments, rather than to the banks which certainly had a valid claim on them. This question of property rights is one which underpins many issues in the Chinese financial sector.

As for "political" lending the authorities position is very clear, that banks should be allowed to make their own credit decisions. But of course the culture takes some time to change.

The second leg of the strategy has been the introduction of strategic shareholders into these institutions. So far, they have been allowed to take relatively modest stakes, with the largest individual shareholding being HSBC's 20% of Bank of Communications (slide 12).

In one sense, these look surprising transactions. In how many countries would large global banks be prepared to take modest minority shareholdings, which are never likely to be allowed to grow into something which brings significant control over the institution concerned, and where the majority and dominant shareholder remains the government? I suspect only China could pull off this trick. Are these banks making a terrible mistake? Will they be captive shareholders, whose interests are not considered if times are rough? Or can they turn these stakes into a meaningful economic interest over time?

It is too soon to be able to answer those questions definitively. I think it highly unlikely that the Chinese government will allow any foreign institution to take anything approaching a majority stake. But it may be that they are allowed to develop 50-50 joint ventures in areas where the Chinese banks lack crucial skills, whether in management or I.T. That might be true in the credit card market for example, or in the leasing industry.

But at least the strategic investments will soon know what value the market attaches to their significant shareholdings. Two of the three big IPOs have already taken place, and on a massive scale (slide 13). The China Construction Bank raised over US$ 9 billion, the Bank of China raised US$ 13 billion, and it seems likely that the ICBC IPO will raise around US$22 billion, making it perhaps the largest IPO of all time. So by the end of this year 3 of the 4 big banks will be out there in the market place, with quoted shares, a stronger capital base, strategic shareholders bringing new skills to them, and the ability to operate overseas on a large scale in they wish. The fourth bank, Agricultural Bank of China, presents a problem on a somewhat different scale to the others, and it may be some time before it is able to take its place on global equity markets.

WTO

But will all this be enough? Particularly, if the big four continue to dominate their own domestic market, with relatively little challenge to that dominance. Will banks with a huge captive domestic market have the genuine incentive to become globally competitive?

One response to that question is to point to the implications for domestic competition in China of membership of WTO. China made major commitments in relation to financial services as part of the WTO application process, beyond the strict obligations that would necessarily be implied. By the end of this year, in principle, RMB business will be open to all foreign banks in China, without geographic restrictions such as have been imposed so far. (Slide 14)

The implications for foreign banks will be considerable (slide 15). In principle, again, they will be eligible for national treatment, alongside Chinese banks. They will be allowed to conduct RMB business, albeit it is likely that there will be some restrictions on its coverage and scope. There may well be some encouragement for foreign banks to establish themselves in developing parts of the country, and there will be common regulatory standards for all financial institutions. But, realistically, it is likely to take some time for foreign banks to make a significant impact in the market. When one thinks that ICBC have 18,000 branches, and even HSBC has only a handful at present, one can see the scale of the challenge. So it is unlikely that WTO membership in itself will bring about a radical change in the competitive environment, sufficient to impose new market disciplines on the big four Chinese banks. So there remains a lot to be done.

What, then, is the future reform agenda, and the challenges which the authorities face now?

<u>Key challenges for the banking system</u>

It is clear that fundamental banking industry reform is far from complete (slide 16). In particular, it is very important to ensure that the major state owned banks whose balance sheets have been significantly improved, and which have been re-capitalised at some cost to the government, do not repeat their past mistakes. That will involve upgrades to the management expertise of those banks, and in particular, and enhancement of their internal controls and their expertise in risk management. As the currency regime becomes more flexible, banks will face new types of risk, to which they have not been exposed in the past. It will also be important for them to adopt more risk based pricing. Up to now, spreads in China have been quite tightly restricted by the People's Bank. That is gradually changing, and the regime is becoming more liberal, which is positive. When the loan spreads banks could impose were severely limited, it might be argued that there is little point in performing a sophisticated credit appraisal, if there was no way of reflecting the outcome of that credit appraisal in the form of wider spreads.

There is also an important need to standardise internal processes and to centralise information technology to create common platforms across the banks as a whole. And, to reinforce the cultures of risk management, and the importance of good credit control, there will be a need for incentive systems within the banks, to reward good performers. China has made considerable progress in that area, but there is a lot more work to be done.

And there are other banks, outside the big four, where non-performing loans are still too high, and where capitalisation is too thin.

There is also a need to reinforce what the authorities have said about reducing or indeed eliminating the influence of central and local governments on lending decisions. And there is a need to continue to upgrade the regulatory environment.

The importance of continuing to strengthen balance sheets, and to recognise that while the achievements up to now have been considerable, they have not been comprehensive, we can look at the way in which ratings agencies asses China's banks (slide 17). While Moody's classify their long term debt as A2, on the broader financial strength measure no Chinese bank yet achieves a rank higher than D. The Chinese aspiration must surely be to see these financial strength ratings rise in the future.

And of course, as I shall come on to argue, there is an important need to enhance the ability of both domestic stock and bond markets to take their share of the burden of finance in the next phase of economic development. While the banks do not have the assistance in making credit decisions which is given to western banks by visible share prices and visible bond prices, together with credit ratings, there is too much of a burden placed on those banks.

And on the regulatory front, the gradual move towards universal banking in China will mean that the system will have to evolve (slide 18). If banks are allowed to establish their own asset management operations, to get into securities markets, and perhaps even to buy insurance companies, the current 3 pillar system of financial regulation will come under strain.

But in my view the biggest issues for the future are cultural. (Slide 19) That is partly a question of introducing a credit focus, rather than formula lending, as I have explained. But it is also about establishing the kind of creative tensions within the financial system which keep western systems "honest". Within western banks there is an inbuilt tension between lending officers and credit control departments. We expect the credit departments to reject a proportion of the lending proposals put forward by lending officers. That causes irritation to the front line staff in the branches, but it is the way they are kept under control. We expect there to be tensions between the lending officers, the credit department and the risk managers. Credit officers may think a loan, on its own, is perfectly satisfactory, but the risk managers may be concerned about concentration risk. Those tensions can be quite sharp at times. Then is the tension between the bank and its external auditors, who may well argue that inadequate provisions for non-performing loans have been made. And then there are tensions between the banks and their regulators. We do not expect relationships between banks and regulators to be warm and cosy at all times.

In China these creative tensions are difficult to stimulate within an environment in which all the main participants were previously part of a single entity, and indeed where senior staff are moved from place to place for strategic reasons. It is hard to create institutional loyalties in these circumstances, and institutional loyalties are also important in sustaining corporate strategies. These tensions and loyalties will only be developed over time. But it is important to recognise how significant they are.

Capital Market Reforms

As I have explained, the banking system is too important in China. It would be better, for the economy as a whole, and indeed for the banks themselves, if the capital markets were more robust.

After a long period in which the Shanghai market has stagnated, there are now meaningful signs of a revival. The composite index has been rising for the last year (slide 20) and has overtaken the Bombay stock exchange index in the last few months. So it is clear that something is going right in the Chinese equity markets. For a long period while economic growth was racing ahead, the stock market index stagnated. Why was that, and what more needs to be done?

One important reason (slide 21) was that the government's own sizeable shareholdings of companies floated on the market depressed prices. Whenever there was a price rally, investors feared that the government would take the opportunity presented by that rally to unload some of its own holdings. There were also divisions between liquid and illiquid shares. There has been no investor compensation scheme. And there has been an important perception, particularly overseas, that the broking industry in China was poorly capitalised, indeed in some cases not capitalised at all, and that there were significant regulatory problems which needed a firm hand.

Much progress has been made in these areas by the CSRC, though the brokers remain thinly capitalised and probably inadequately robust to provide the infrastructure needed for a significant enlargement of the market. And there remain restrictions on overseas investors in the Shanghai and Shenzhen exchanges which, over time, ought to be removed.

In the case of the bond markets, many changes are needed (slide 22). Bond markets elsewhere are typically robust when there is lively trading, and that trading is stimulated when there is a diversity of different credits available in the market. At the moment, the perception is that almost all Chinese bonds are effectively guaranteed by one government agency or another. Taking the risk of issuing explicitly non guaranteed bonds may seem a curious thing for the Chinese authorities to do. They would be creating risk which they do not need to introduce into the market, and possibly be paying a price for it in the form of wider spreads. But if that does not happen, then in the long run the market will not develop. So what may seem in the short term an irrational move may in the long run benefit the economy.

Beyond that, the bond markets in China will benefit from ratings agencies able to make judgements about different categories of debt, by the existence of secondary and repo-markets, and indeed by the establishment of derivatives, particularly interest rate derivatives. They are the essentially complements to lively bond markets in developed countries.

Corporate Governance

The third dimension of capital market reform, which in many ways is the most important of the 3, relates to corporate governance. The one development in China which would do most to encourage the growth of an equity culture would be an increase in confidence in the corporate governance standards of Chinese companies. And, in particular, in the attention given to the rights of minority shareholders by boards of directors (slide 23).

The CSRC has issued a code of practice on corporate governance, which is excellent. It is a kind of amalgam of British and continental European practice and has much to commend it. It does include an important role for independent directors and envisages the growth of distributed shareholdings. But of course there is a long way between publishing a code of practice and seeing it implemented across the corporate sector, something we have discovered in the United Kingdom over the years. Even now, there are many companies which do not fully comply with the terms of the Higgs code of corporate governance. That is certainly still true in China, both in relation to the letter and to the spirit. It is an area in which the regulators will need to do more in the future.

Regulatory Reform

There is also a continuing agenda of regulatory reform (slide 24).

When the Chinese authorities last gave detailed consideration to the regulatory structure they decided to create 3 separate Commissions, for banking, securities, and insurance. In the circumstances of the time, this was an entirely appropriate move. The 3 sub-sectors of the financial industry were quite separate, and companies were not allowed to operate across borders, so to speak. And over the last 5 years those commissions have developed their expertise and their reputations greatly.

Two of them, the CBRC and the CSRC, have set up International Advisory Councils which they use very effectively. In fact there are quite few countries, the UK and China the only two I can think of, where international advice is frequently taken about the nature of the regulatory regime.

But there is a lot more to do in terms of staff training. The bar is always being raised in the world of financial regulation. The demands on regulators today, implementing complex new arrangements such as Basel 2, are considerably more difficult than they were a decade ago. So upgrading technical skills is essential and, as I have already described, the creation of a cultural of challenge in the regulator, encouraging and emboldening the staff to question and sometimes disagree with their clients, is vital. That is not easy to create in the UK, and it is more difficult to do so in the Chinese environment.

It also seems likely that, over the next few years, institutions will be allowed to operate across the sub-sectors of the financial world. We know that there is a demand to do so by domestic firms already. And there are many respects now in which the regulatory regimes of the 3 different Commissions interact with each other. At the very least, there is a need for an overarching body to resolve inconsistencies and to promote cooperation between the Commissions. And it may be – as the Chinese authorities have already explicitly envisaged – that the time will come when it is appropriate to create a single regulator. That would, of course, be a very powerful body in China and would need to be surrounded by appropriate checks and balances and accountability frameworks.

Implications for the global financial system

All these reforms are difficult, but achievable. So we can expect that the Chinese financial system will continue to evolve, and in particular that it will continue to open itself to the rest of the world both in terms of domestic competition, and in terms of the international ambitions of Chinese banks themselves (slide 25).

What will the implications be?

The most obvious point is that there will be huge new competitors with at least regional and possibly global ambitions. By the standards of other banks in Asia, the big 4 Chinese banks are very large indeed (slide 26). Their balance sheets dwarf those of other internationally active banks headquartered in the region, except Mizuho. In the past, they have not been particularly effective competitors, largely because they have not been adequately capitalised to operate overseas. For the most part they have not met Basel capital standards, which has limited their ability to establish operations in other financial centres. In future, at least 3 of the big 4 will be adequately capitalised, and will be able to establish themselves in major financial centres and to conduct a wide range of business from them. They will be more effective competitors also because they will be supported by knowledge transfer from their strategic shareholders. Their business base may be narrow in the first instance, outside Asia, and I would expect them to focus on trade finance and on meeting the needs for their Chinese clients overseas.

The bigger question is what kind of strategies they come to adopt. Will they make mistakes of the Japanese banks in the 1980s? It is now easy to forget that in 1989, the Japanese banks accounted for almost 30% of the assets of the London banking system. They went for market share, at the expense of margin, and were prepared to undertake syndicated lending at very fine margins indeed. They were not as margin sensitive as other banks with more demanding shareholders. Will the Chinese do the same? I hope not. The example of the Japanese is there before them. From 27% of the market in London in 1989, they now have perhaps 3%. This has been one of the most significant booms and busts in financial history. The Chinese would do well to avoid repeating it.

In the other direction, there will clearly, under the WTO arrangements, be new openings in China for foreign institutions, but particularly for those with targeted competitive offerings. Trying to compete across the board with ICBC in its 18,000 branches is unlikely to be a successful strategy. But there will be opportunities for foreign currency business, to support the financing needs of foreign companies in China, and perhaps to meet the aspirations of higher net worth Chinese investors as soon as they allowed to invest overseas, which I would expect to happen. There may also, as I have explained, be interesting joint venture opportunities in areas where the Chinese institutions remain weak.

Conclusion

We have seen a remarkable exercise in financial sector restructuring in China over the last two decades. It started, perhaps, not so well and the Chinese may have claimed too much too soon for their commercial banks. But for the last 5 years there has been a clear strategy, at least for the big 4. That strategy is, however, now coming to an end and the new government, with a new financial conference in Beijing next year, will need to make new decisions about the future. How much of these banks will be floated? Will they seek floatation on markets other than Shanghai or Hong Kong? How large will the stakes of overseas financial institutions be allowed to become? Will it be possible to establish 50-50 joint ventures, even in the retail market?

There are similar significant questions in the equity markets. How much freedom will Chinese investors be allowed in the future? It is arguable that the Chinese financial system has been very strongly oriented to the needs of borrowers and corporates, with the investment needs of individuals a rather secondary consideration. With such a high savings rate, Chinese consumers need better outlets for their money. This will mean more flexibility in investment offerings, both domestically and perhaps overseas. There could be significant advantage in allowing a unification of share classes on the stock exchange, and also allowing Chinese citizens more freedom to invest overseas at the same time.

There will also be, as I have pointed out, some interesting and difficult decisions to make on the structure of the regulatory system. And, beyond that, there are bigger questions about the way in which institutional cultures can be developed in the new financial institutions which have emerged from the re-structuring process so far.

The continued reforms of the Chinese financial system will in many respects be a microcosm of reforms in the economy as a whole. For that reason, and because the introduction of competition may have unpredictable consequences, it will continue to be a fascinating area to observe in the years to come.