



Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government

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China's state-owned banks -- riddled with inefficiency and loaded down with bad loans -- represent a serious drag on the world's most vibrant economy, according to participants at the 2005 Wharton China Business Forum. "The four major state-owned banks are technically insolvent," said Wei Christianson, China chairman for Citigroup Global Markets Asia and a speaker at the Forum. "They are trying -- and mostly failing -- to be globally competitive. They have weak governance, bureaucratic cultures and staggering levels of non-performing loans."



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That said, the "Big Four" -- Bank of China, Commercial Bank of China, China Construction Bank and Agricultural Bank of China -- are attempting to reform themselves, in part by implementing Western-style management practices and prudent lending standards. In 2003, China's government recapitalized Bank of China and China Construction Bank with an injection of \$45 billion of reserves -- a sign that bank reform is a priority for the still-powerful central government.

"The government is under pressure to sustain economic growth," Christianson pointed out. "And sustained growth doesn't happen without a healthy financial system." Banks provide the bulk of funding to China's businesses because the country's stock and bond markets are still in their infancy.

The Big Four's main problem is their non-performing loans, Christianson said. Bankers classify a loan as non-performing when the borrower isn't paying interest and principal according to the original terms. Standard & Poor's has estimated that 40% of these banks' loans -- or about \$800 billion worth -- are non-performing. China's government insists the level is only 25%. "Either way, the cost is substantial," Christianson said. The concern is that the repayment of many of these loans will cease, and they will have to be written off as losses.

Historically, state banks have made loans based on political directives from the national government in Beijing, not on which companies had the best prospects or which economic sectors were thriving, Christianson said. These so-called "policy loans" typically went to state-owned enterprises. In addition, the banks have been plagued by poor credit management, a lack of qualified staffers and occasionally corruption, she pointed out. To avoid a financial crisis like the one that shocked the rest of Asia in 1997 and 1998, China needs to undertake a thorough program of reform, including both macro changes to the banking system and micro changes to the banks' management, Christianson argued.

The central government already has begun to encourage foreign investment in the banking sector by forcing smaller banks to seek out strategic partners, Christianson noted. So far, 11 Chinese banks have done so. In 2003, for example, Shanghai Pudong Development Bank teamed up with Citigroup, which bought a 5% stake in the Chinese firm. In 2001, the Bank of Shanghai paired with United Kingdom-based HSBC Holdings, which has invested more than \$2 billion in Chinese banks and insurers. In addition, China formed a bank regulatory commission a year and a half ago that has promulgated about 60 regulations intended to shore up the state banks' finances.

Even so, much work remains to be done, Christianson said. The banks, for example, need the ability to appoint their own boards and make truly independent lending decisions. Though the central government has dialed back its interference with the banks' operations, "local decisions are still influenced by provincial governments' policies," not the creditworthiness of borrowers. The banks also must be reorganized internally. "They need accountability, checks and balances and independent audits."

At present, bank operations are organized geographically, instead of by line of business. And they have numerous branches arrayed across the country. "They need to rationalize their branch networks," Christianson argued. "Tear them apart and start over by closing and merging branches."

Strengthening the banks' human resources and information technology departments will aid in these efforts. As it stands, China's big banks don't compensate their personnel based on performance, and their IT systems, where they exist, are unsophisticated. "You are probably wondering why the banks' managers haven't done these things," Christianson said. "I'll use China Construction Bank as an example. It has had three or four governors since the mid 1990s. Each one said, 'I am going to establish a modern IT system,' but they have each gone down a different path. Now the bank has a mixed IT system that doesn't work."

Though her analysis makes China's banks sound like they are continuing to spiral downward, Christianson said she's optimistic about their future, as is her employer, Citigroup. "We have 1,200 people in Shanghai alone," she pointed out. "We have moved back-office operations from India to Shanghai." Her hopefulness stems from the Chinese government's commitment to reform in all sectors of the economy. "Starting in the early 1980s, the pattern has been three steps forward, two steps back, but the direction has been forward."

Bank reform likewise has zigzagged. But the government is clearly committed to it, as shown by the recapitalization of Bank of China and China Construction Bank, she said. Moreover, as a condition of China's accession to the World Trade Organization, the country's banks must be ready to compete with foreign firms in 2006. A daunting possibility is that one of the Big Four might collapse when faced with competition. Christianson thinks that is unlikely: "The Big Four have major market share, so the government will do anything to prevent that," she said.

Underground Lenders

As a result of the inefficiency of China's banks, an informal financial sector sprang up long ago to serve enterprises that weren't the beneficiaries of government largesse, especially small and medium-sized firms, said Xiao Feng, vice chairman and CEO of China-based Boshi Fund Management Co.

"There has been a mismatch," he noted. "State-owned enterprises account for 25% of gross domestic product, but get 65% of the loans. Quasi-private enterprises account for 45% of GDP but only get 20% of loans." The quasi-private firms therefore have turned to informal -- some would say "underground" -- lenders. These outfits tend to operate in a single village or city and do business with people they have known for years. As a result, they are able to make loan decisions in minutes that would take the official banks weeks, if they got made at all.

The informal lenders' interest margin -- the difference between what they charge for loans and pay for deposits -- is typically twice as large as the banks, which means they are far more profitable, Feng said. "Sometimes, state-owned enterprises even borrow from the big banks at 5% or 6% and then lend the money underground at 10% to 12%," he pointed out. The role of the underground lenders probably will diminish as foreign banks enter China and the country's capital markets develop, he predicted.

In the United States, big companies tend to turn to the stock and bond markets to finance their activities, Feng pointed out. As a result, commercial banks have to court small and medium-sized business more aggressively. In China, where the capital markets have only just begun to develop, big banks have not

faced the same pressure. "In China, 74.9% of financial assets are in bank deposits, while only 3.3% are in equities," he noted.

Like Christianson, Feng is optimistic about the future of banking in China. Preparation for foreign competition is forcing the banks -- with goading from the government -- to reform. And the government itself has made diversifying the country's financial system a key goal.

Feng drew an analogy with Japan's banking sector, which has lately emerged from a long slump. "Look back 10 years ago at the Japanese system," he suggested, "and lots of banks were in financial difficulty."

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