China's Banking Market for Foreign Investors after the WTO Accession

Dongwook Lee[Ø]

[W]ith an ineffectual central bank, a highly fragile banking system, and nonbank institutions lacking an effective regulatory framework, the stage is set for financial crisis. Thus far, the perverse one-way drain of the banks' resources [to the state sector] has not brought on a financial crisis. [N]onetheless, that the system has not collapsed does not signify the absence of crisis risk.

Charles Wolf, Jr. et al. *Fault Lines in China's Economic Terrain* [1]

Despite sporadic news coverage [2] and publications about potential risks of investments in China, many foreign investors bravely rushed there. As early as the dawn of the 19th century, British merchants were calculating numbers: they figured out that if every Chinese person bought a shirt, the textile machines at Lancaster would be occupied for many years. However, even by the days of the British Empire's decline, they did not see as many silver dollars as they had dreamed of seeing. [3]

"The mysterious Chinese market" [4] has inspired in countless foreigners "the most attractive imaginations." [5] "Foreigners, for various reasons and in many ways, have been fascinated, even blinded, by China, so it has been difficult for them to see the facts." [6] Case in point: many international financial giants eyed the Chinese market after China's entry to the WTO in spite of the fact that the American-based Lincoln Financial Group [7] decided to leave China in 1998 after nearly ten years in the country. By itself, the entrances and exits of foreign financial organizations are normal occurrences; the exit of Lincoln Financial Group may not entail anything profound. Those in China who were worried about "the invasion of foreign financial capital" [8] might even have had reasons to celebrate the exit. But today, those who are thinking of making inroads into the Chinese financial market or those who already have a presence in China may learn a lesson from the case of Lincoln Financial Group--not to waste ten years' efforts and the bear the cost of waiting as the company did.

This article analyzes the problems and challenges of China's financial market, especially the banking sector, for foreign investors after the WTO entry of China. Part I introduces this article. Part II discusses the general environment of China's banking sector. Part III analyzes the Chinese banking sector's potential problems, which are not well-recognized by foreign investors. Part IV concludes this article with homework for foreign banks to do.

China's Banking Sector

1) The Chaotic Status of China's Banking Sector

To make a long story short, the Chinese banking industry is in a muddle. Some would say "the banks in China are either on the verge of a bust or boom." [9] The emergence of a wealthy Chinese middle class coupled with new banking regulations makes the banking industry appear poised for massive growth; the new middle class may become significant depositors. But at the same time, Chinese banks are "plagued by bad debts" [10] and inefficiency. [11] According to Michael Pennington, "they are also facing a huge potential loss of customers to their foreign counterparts once the industry has fulfilled its WTO commitments and opened up fully by 2007." [12] Many China watchers say fixing China's banking problems is more urgent than fixing Russia's. They do not hesitate to say "the pace of financial reforms has lagged far behind other areas--- and nearly every China 'nightmare' scenario [13] begins with a banking crisis." [14] According to Dr. Li Wei, vice-chairman of China Banking Regulatory

For personal use only; do not reproduce without permission of the Harvard Asia Pacific Review.

Photo by Stijn van der Laan

Commission, [15] China's banking industry is facing three major problems: [16] i) overdependence on the banking sector for financing, ii) serious non-performing assets in the banking industry, and iii) poor corporate governance and management.

i) Overdependence on the Banking Sector

There are four-types of banks in China: wholly state-owned banks, partially private banks, credit co-operative banks, and foreign banks. About 70% of the Chinese banking assets are dominated [17] by the four wholly state-owned banks (SOB): the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), and the China Construction Bank (CBC).

According to Xinhua News Agency's September 15th , 2004 news report [18] quoting the figures of National Bureau of Statistics of China, [19] the total assets of various banks in China at the end of August 2004, were 2.97 billion yuan (US$357.8 million), making up 90 percent of capital [20] of all financial sectors in China. This figure shows that China's capital markets are not functioning well enough to finance its capital requirements, which is quite contrary to the Chinese government's pompous advertisement about its stock markets: from a base of less than US$1 billion in 1990, China's total stock market capitalization swelled to over US$500 billion in the end of 2003 with over a thousand listed companies. [21] Despite China's continuing drive to make capital markets a primary financing channel, 90 percent of the funds raised in the stock markets and all of the funds from the bond market go to state-owned enterprises (SOE) and the government. And a large portion of those listed shares are not transferable, [22] even after going public. That is why James A. Dorn, Vice President for Academic Affairs at the Cato Institute, named China's securities markets "pseudo capital markets" [23] at the public hearing on China's Capital Requirements and U. S. Capital Markets before the US-China Commission of the Congress on December 6, 2001. Since Mr. Dorn's testimony in 2001, there have been no signs that China's financing pattern has dramatically changed. Up until the moment China has a real capital market rather than exhibiting "capitalist propaganda," [24] this trend of overdependence on banking loans might not be solved.

ii) Serious Level of Non-performing Loans

Since 1994, all four banks have changed themselves from their original mandate [25] when the government created the so-called policy banks in order to take over the Big Four's state-directed lending role. But despite the Big Four's move away from a policy-directed lending function [26] toward commercial lending, "the legacy of their past lending continues to constrain their earnings and profitability." [27] While

For personal use only; do not reproduce without permission of the Harvard Asia Pacific Review.

it is widely acknowledged that Chinese banks are saddled with heavy non-performing loans (NPLs), [28] the actual amount of NPL is a subject of debate. [29] According to the official statistics of the People's Bank of China (PBOC), the central bank of China, NPLs at the big four banks stood at 2.4 trillion yuan or about US$ 292 billion or 15.19 % of total assets at the end of 2003. [30] But China's Banking Regulatory Commission (CBRC), announced that the NPL ratio was 19.6 percent. [31] Private estimates, especially by those abroad, are much higher, however, putting the big four's NPL ratios in the range of 30-50 %: "The vast difference in the NPL estimate could be due to either to different methods [32] or subjectivity of the evaluators." [33] Although the Chinese government would not allow the state-owned banking system to collapse, the banks cannot restore their solvency unless enterprise performance improves substantially. The high level of NPLs, however, complicates the banks' provision of funds that enterprises need to restructure and improve their performance. [34] This weakens efforts to improve the banks' credit culture and blunts incentives for enterprises to improve their governance. Poor governance, in turn, blocks the development of capital markets as alternative financial outlets. Likewise, an OECD [35] study argues that a severe vicious circle has developed in China. [36]

With less than three years until foreign banks attain full rights to operate under the WTO rules in China, the Chinese government has introduced wide-ranging reforms to give domestic banks a fighting chance. They include improving central bank independence, reducing the burden of past policy loans, adopting a new loan classification system, relaxing control over interest rates, establishing asset-managed companies, further opening China's banking sector to foreign banks, strengthening the supervisory and regulatory environment, and implementing sound banking practices. As a way to divest itself of the four giant SOBs that hold most of the NPLs, the central government decided to allow the Big Four to go public: the CBC in 2004, the BOC in 2005, followed by the ICBC and the ABC. The complex financial restructuring of the CBC and the BOC, the first state-owned lenders seeking overseas listings, however, will delay their initial public offerings until at least the middle of next year [2005]. [37] But the key concern remains: whether the politically induced bank reforms will save the problem-riddled sector. If the banks are to compete in the international financial market once they are privatized, they must clean up "their culture of irresponsibility and inefficiency." [38]

iii) Poor Management and Political Interference

Interestingly, the People's Daily, the mouthpiece of the Chinese Communist Party, ran an article on August 13, 2004, titled "Policy Support Needed in ICBC Reform." [39] ICBC is the largest wholly state-owned commercial bank of China. The newspaper claims, "China's largest state-owned commercial bank will be able to solve its long-standing problems of high non-performing assets, insufficient bad loan provisions and low capital adequacy within three years if the State gives 'appropriate support.'" [40] No country's largest commercial bank would typically admit to such implications; this article suggests that Chinese banking sector is indeed still in a poor state of management and corporate governance that is plagued with political interference from the State, although it does note that "the pace and the scope of regulatory reform of China's financial industries might have advanced markedly" [41] after the WTO entry. [42] Dr. Sebastian Heilmann, Professor of Trier University in Germany, explains in his June 2004 paper [43] why China's banking sector cannot be free of political interference and cannot have an efficient management system and desirable corporate governance. He argues that the conflicting mandates that the central political principal (the Communist Party's top leadership) wants its administrative agents (the financial regulators) to fulfill are at the heart of persisting deficiency in China's financial regulation. [44] On the one hand, China's political leaders seek to gain credibility in the construction of financial markets by establishing a regulatory system that is in accordance with international practices. Ironically, the political leaders are also determined to maintain political control over regulatory bodies and financial firms by means of Communist Party care, appointment, and supervision. [45] Heilmann's theory explains why Chinese Party bodies claim control over executive appointments even if the majority of shareholders in financial firms come from the private sector. For example, in 2003, Chinese Party bodies appointed senior executives in non-state financial commercial institutions such as Minsheng Bank, [46] although they did not manage the supervisory board of the bank.

2) China's WTO Accession and Its Impact on the Banking Sector of China

After 15 years of negotiation [47] with the member countries of the WTO, China became a member of the WTO on December 11, 2001. Since the accession to the WTO required further liberalization of foreign trade both in industry and agriculture, the enormous benefits to China did not come for free. China promised the world that it would comply with its commitments to open up financial markets, especially the banking market. [48] Even so, China is structurally limited in the amount of financial liberalization it can undertake.

Among other things, the government needs to actively restrain foreign banks from accepting RMB deposits in order to compete with domestic banks, and also to restrain foreign financial institutions from undermining the capital controls by transacting freely between foreign and domestic currencies. [49] First off, for more than twenty years, the Chinese government has covered its large implicit fiscal deficits by borrowing from the state-owned banking system – whether it be in the form of policy loans for infrastructure investments or loans to prop up loss-making state-owned enterprises. For the most part, these loans cannot, or will not, be repaid. [50] Thus, domestic Chinese banks are encumbered with a portfolio of nonperforming loans which are the implicit debts of the government – but do

For personal use only; do not reproduce without permission of the Harvard Asia Pacific Review.

not bear true interest in the short and medium terms. Admitting foreign banks, which are not so encumbered, to bid for renminbi (RMB) [51] deposits would not be fair competition. [52] Secondly, there is the major problem of maintaining prudential controls over 'hot money' [53] flows. If foreign banks are allowed to move freely between dollars and RMB, then domestic banks will clamor for the same privilege. But because of their bad loan portfolios and eroded capital positions, domestic banks have a more serious problem of moral hazard, i.e., more of a proclivity to gamble by taking exposed positions in foreign exchange. As such, like domestic banks, foreign banks may have to be restricted in foreign exchange transactions.

China should be congratulated on its accession to the WTO, but it is likely that the liberalization of trade in financial services, in practice, must proceed much more slowly than the liberalization of trade in goods and non-financial services. [54] Consider furthermore examples suggested by the United States-China Business Council in March 2001. [55]

The PBOC and the Ministry of Finance (MOF) initially moved most quickly among the various ministries to implement WTO commitments, announcing that auto financing and retail foreign exchange services for current account transactions were open to foreign entrants on the very first day of WTO accession. [56] Implementing rules for application procedures, however, has been slow to emerge. Local currency business for foreign clients was permitted from the first day of accession in Dalian, Liaoning; Shenzhen, Guangdong; and Tianjin, though foreign banks could already conduct such activities on a provisional basis before the accession to the WTO. Foreign banks were allowed to conduct local currency business with Chinese enterprises in 2004 and with Chinese citizens in 2006. Fears that expansion of foreign bank loan operations would be slowed by high capital adequacy requirements and the need to hold such reserves in China have been borne out in revised regulations implemented from February 1, 2002. [57] Though China's WTO commitments detail entry requirements in terms of foreign players' total assets, China is free to raise operating capital, registered capital, and capital adequacy ratios. [58] The new rules of 2002 set levels exponentially higher than in other markets.

3) Foreign Bankers' Inroads into the Chinese Banking Sector

By March 2004, 62 foreign banks from 19 countries and regions had established 195 operations in the country. [59] In order to induce more foreign banks, China passed legislation that revised the Rules for Implementing the Regulation Governing Foreign-Funded Financial Institutions in the People's Republic of China. [60] The revised rules, which became effective on September 1, 2004, simplified the examination and approval process for foreign banks to set up China operations and to make yuan transactions. [61] But in terms of business, however, the total banking assets held by foreign banks all together are about 37.9 billion US Dollars as of the end of May 2004, a little more than 'one percent of the whole banking assets' [62] in China. Three years ago, when China first opened its banking market according to the WTO commitments, 'domestic banks decried the coming of a wolf,' [63] perceiving foreign banking competitors as predators.

Photo by T. Al Nakib

For personal use only; do not reproduce without permission of the Harvard Asia Pacific Review.

Perhaps, since foreign banks have been operating in China for three years, domestic banks are a little more used to the idea of such competition now. Experts explained some shortcomings in foreign banks' operations in China, such as a lack of a management network compared to Chinese banks, which will take time to establish. [64] Another difference is that Chinese banks fill profit margins mainly through the difference between interest rates of loans and savings, while foreign counterparts profit increasingly through supplying services. For example, while foreign banks take in high service fees, domestic banks offer free deposit and withdrawal services.

These shortcomings may limit foreign banks' development in China even in the future, but they still do not fully explain the sluggish performance of foreign banks in China. "From the current base of 1 percent, split among 190-some licensed foreign banks," [65] this banking sector will grow quickly after 2006. However, even the most optimistic outlook would suggest foreign banks will not achieve a market share of more than 10 percent by 2010 and even that would require a doubling of market share each year from 2006. [66] From the moment the foreign bankers expand the market share of the Chinese banking sector, however, it is the author's belief that the intriguing Chinese mechanisms will likely start to hamper foreign banks. This interference may tiptoe between China's market opening commitments and China's nationalism to protect the assets of the people. In the next section, this article examines what may turn out to be the pitfalls for the foreign banks already in China or those planning to be in China.

The Hidden Bombs of Chinese Banking Market

1) Lack of Banking Culture

The biggest potential problem of the Chinese banking sector, one that will reveal itself more conspicuously when the economic growth of China staggers, is the problem of "welchers," [67] according to Gordon G. Chang. Welchers in China can be any individuals, enterprises, or organizations that do not pay back their bank loans. "While Islamic banking conforms to the strict Muslim teaching prohibiting interest, it would seem that communist Chinese banking could be defined as never having to pay loans." [68] In the mindset of Chinese borrowers, there is a philosophy that "it is better to repay late than repay early, and it's better not to repay than to repay late." [69] There are many explanations for this Chinese endemic of welchers. According to John M. Mulcahy, who has been covering Asia for 20 years as a journalist with South China Morning Post and the Far Eastern Economic Review magazines and as equity research head at Peregrine and UBS, "That is not surprising given the history of banking in China up to 1979." [70] Fundamentally, China has its founding principle [71] as the nation of "the class of the wholly property-less, who are obliged to sell their labor to the bourgeoisie in order to get, in exchange, the means of subsistence for their support. This is called the class of proletarians, or the proletariat." [72] "Assertion of property rights has hardly been the cornerstone of China's financial system over the past 50 years." [73] The ability to recover debts by foreclosing and attaching assets is still in its infancy. For example, courts generally won't rule against a state-owned enterprise, and even if they do, court orders have enforcement problems. [74] Even though the Law of the People's Republic of China on Enterprise Bankruptcy (LEB) was promulgated by the National People's Congress on December 2, 1986 and became effective as of November 1, 1988, it still does not seem to be functioning as originally intended. [75] Gordon G. Chang even says "bankruptcy rules are meant to protect the debtors owned by the state." [76] "The situation has gotten so bad that repaying a loan would put borrowers at a competitive disadvantage with all those who do not pay." [77]

With the arrival of Citibank, HSBC, Deutsche Bank, Tokyo-Mitsubishi Bank, and other major multinational banks, the quality of China's banking system has improved, but it will not come close to addressing the intrinsic flaws in the system that are very rampant in China while the nation is in "the transformation from a guanxi [relationship] society to a rule-based society." [78] Although multinational banks are cautiously selective about giving loans [79] to the Chinese sovereigns, [80] enterprises, and individuals, one of the Chinese bombs called the trait of welchers is ready to explode any time. In December 2000, when the first distribution of the bankruptcy assets of the Guangdong International Trust & Investment Corp(GITIC) [81] was sent out to creditors, marking the beginning of the end of the largest bankruptcy in the history of the People's Republic of China, the incident gave many important lessons and precedents for foreign lenders and investors. The Asian Wall Street Journal [82] listed examples of such lessons, including 1) no company is too big to fail, 2) foreign creditors do not have preference, 3) all foreign debts must be registered, 4) comfort letters are not enforceable, 5) Chinese legal opinions are to be treated with caution, etc.

All these lessons can be summed up with the simple fact that China needs culture – credit culture, that is.

2) Listing Problems

China 's former premier Zhu Rongji (himself a former head of the People's Bank of China) once stated that "the resolution of the banking problem would be for another generation." [83] If the banking problem is a generation-long issue to tackle, the listing plan of four Chinese state-owned commercial banks will reveal the problems that may become evident within only a few years. Consider a short news article from the January 30, 2004 issue of the China Daily about the listing plan of Chinese SOBs:

> The Bank of China and the China Construction Bank, two of the country's largest four state-owned commercial banks, are planning for public listing at overseas stock exchanges. The China Construction Bank hopes to be listed at the Hong Kong and New York bourses in 2004, garnering up to US$10 billion and becoming the largest listed com-

For personal use only; do not reproduce without permission of the Harvard Asia Pacific Review.

pany in the world for the year. The Bank of China planned to get listed in 2005. At the end of 2003, the Chinese central government injected US$45 billion of foreign reserve into the two banks, US$22.5 billion apiece, to activate the business performance of the two state banks. [84]

This article does not depict all the potential problems foreign investors may end up with if the listing plan of the Chinese banks materializes. But we can get many hints from the relatively recent news article. First of all, the news media of the world as well as the multinational investment banks involved with the listing plan of the state-owned commercial banks do not indicate that the SOBs, regardless of listing, whether in China or abroad, are subject to the orders of State Council of China, which is under the control of the Communist Party. Article 41 of Law of the People's Republic of China on Commercial Banks stipulates:

> The State owned commercial banks should issue loans to special projects which have been approved by the State Council. The State Council will adopt corresponding measures to make up for the losses of the banks because of issuing the loans. To adopt what measures is up to the decision of the State Council. [85]

Second, the aforementioned Chinese banks' assets did not improve by the efforts of the banks' management, but by the government support. Therefore, even after all the above banking shares are placed to the foreign investors, chances are the banking assets of those banks may deteriorate again by the poor management and the poor governance. And the news report does not clearly indicate how the management, without the support of the government, would handle the old NPL as well as the new NPL.

Third, Chinese banks are still operating in an economic system in which political influence is the main currency. Therefore, legally speaking and economically speaking, Chinese banks, without any commercial consideration, should follow the instruction of the State Council. Even after the bank loan is made to special projects ordained by the State Council, the repayment method will be decided not by the lending banks, but by the State Council. The consequences of such an arbitrary order of the State Council will be reflected in the share price if the SOBs are to be floated in any overseas stock markets. Eventually foreign investors may end up as the victims of such Chinese shares.

No wonder economists say China's banking sector is run by "the invisible hand that is tied up by the visible hand." [86]

3) Other Miscellaneous Problems

In addition to the aforementioned problems of the banking sector, there are miscellaneous problems such as the division of supervisory power between the CBRC and the PBOC and the lack of markets for handling the NPLs, etc. Improvement of corporate governance, accounting standards, and the regulatory framework are essential to bring China's banking sector standards in line with international standards. In addition, a more flexible monetary regime will be necessary to allow banks and financial institutions to price risk more accurately and increase the efficiency of the system. [87]

Conclusion: Homework before Heading to China

In fact, there is a strongly held view among some economists [88] in China that the country should simply shut the door on the past and write off all problem loans, starting with a clean sheet of paper. [89] That, of course, is easier said than done: even closing the big four banks will not necessarily give rise to a new banking culture of fiscal rectitude among the Chinese borrowers, especially SOEs. Still, mastering the challenges in the banking sector is urgent for the Chinese authorities in light of the WTO obligations in which all major restrictions on the participation of foreign banks in China's financial sector are to be lifted by December 2006. China's banks need both capital and an internal structuring to meet the upcoming increased competition. But considering that the Chinese banking problems are more deeply rooted than they look, the Chinese authorities may continue its strategy to have all the strings attached to the market opening for the foreign bankers. It is also very likely that the Chinese authorities will continue its strategy of market intervention. [90] After all, Beijing will do everything in its power to keep the state banks alive, a policy that, nonetheless, does not mean that they are assured of survival. As Gordon G. Chang puts it, it just means that "of all segments of economy, banking will be the last to fall." [91]

The advent of foreign banks in China will mean better service for Chinese customers, but it will come at a cost not only for those customers [92] but also for the foreign bankers themselves. A recent issue of the Beijing Business Review Magazine tells us that Citibank's individual banking business worldwide reached $9 billion in 2003. [93] And yet, the operation in China is currently running at a loss; it just goes to show that even a multinational bank like the Citibank needs to do more homework before heading to this particular country. When the listing plan of those Chinese banks materializes, it is very likely that many foreign banks will want to have a slice of those banking shares. But even after the foreign banks become the major shareholders of China's four biggest banks, the Chinese authorities will probably still not let go of the control over the domestic banks. The Chinese banks will still be under the control of the Article 41 of Law of the People's Republic of China on Commercial Banks without any significant improvement of management skills or corporate governance. And about the time when the bombs start to tick in the banking sector, it will be too late for the foreign banks to fix the problems or to exit without damages.

For endnotes, see online supplement (S6).

Dongwook Lee is a former senior analyst of the Chinese economy at the Korea Center for International Finance in Seoul, South Korea.

For personal use only; do not reproduce without permission of the Harvard Asia Pacific Review.