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Banking reform in China:

Driven by international standards and Chinese specifics

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Abstract:

This paper reviews the progress of banking reforms in China over the last five years. The stated goal of reform is to "transform major banks into internationally competitive joint-stock commercial banks with appropriate corporate governance structures, adequate capital, stringent internal controls, safe and sound business operations, quality services as well as desirable profitability." The reform strategy relies on three pillars – extensive publicly-financed bailouts, implementation of the international best practices in bank governance and regulation and listing of major banks at the Hong Kong stock exchange. This strategy has been successful in stabilizing the three major banks. However, our review of academic and commercial research indicates that there is no evidence that the stabilization is sustainable. Prudential indicators of the largest banks are comparable to international averages, but this is an outcome of large bail outs and ongoing credit boom rather than fundamental change in banker's incentives. Reforms of bank governance and regulatory framework need more time to proliferate throughout the banking and regulatory hierarchies. However, time alone would not solve the problem as the reform design retains important departures from international standards. These standards are implemented in a selective manner; those aspects that help to concentrate key powers in the center are implemented rather vigorously, whereas principles that require independence of banks' boards and regulators are ignored. Thus the largest Chinese banks remain under the firm state control and can be used as development policy tools for the better or the worse.

Keywords: China, banks, reform, international standards
JEL classification: G21, G28, P34,

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Introduction

The purpose of this paper is to address the question whether reforms of the largest Chinese banks implemented since 2002 turned them into independent commercial entities that operate in line with the best international practices of modern banking. The proposed answer is no. The largest Chinese banks remain under the firm state control, thus state policy objectives dominate over the long term stability of banks. The substantial progress in formal implementation of "the best international regulatory and governance practices", the listing in Hong Kong and presence of minority foreign investors notwithstanding, there is no doubt that should the future course of events threaten economic growth and/or political stability in China, major banks would be among the policy tools used to address the problem regardless of the impact on banks' own financial stability[2].

The regulatory and governance reforms of major banks closely follow international best practices, yet they also retain some important "Chinese characteristics". The policy-makers on the central level use international standards instrumentally to push through reforms on the sub-central levels. However, when these standards require independence of the regulator or bank board, they are tweaked so that the State Council and the Chinese Communist Party remain at the helm of power. Reforms on the sub-central level follow the prescriptions of international standards more closely, but even there it will take more time before they trickle down to every bank branch.

There was major improvement in financial stability indicators of major banks over the last few years[3]. However, there is no conclusive evidence that low ratios of non-performing assets[4], are

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[2] By bank's financial stability we mean its long term solvency and liquidity comparable to international standards and practices prevailing at comparable emerging markets. Given the maturity mismatches inherent in banking portfolios, bank stability also means that bank preserves its reputation as stable institution.

[3] By major banks we mean the Big Four banks - Agricultural Bank of China (ABC), Industrial and Commercial Bank of China (ICBC), Bank of China (BOC) and China Construction Bank (CCB). The term Big Three used in this paper refers to ICBC, CCB and BOC that have already been listed on the Hong Kong Stock Exchange.

results of improved credit culture. They may well be explained by the on-going credit boom that increases the size of credit portfolio (thus reducing the relative proportion of outstanding loans to non-performing assets). As new loans mature, they may turn non-performing as was the case several years after the previous credit boom in early 1990s. On the other hand, reforms to date prevent some of the early 1990s excesses[5] and thus should reduce potential losses to more manageable volumes. Whether future losses could be resolved by banks alone or whether they would require yet another state financed bailout remains to be seen. In short, banking reform in China depicts some progress towards the proclaimed end goal – "to transform major banks into internationally competitive joint-stock commercial banks with appropriate corporate governance structures, adequate capital, stringent internal controls, safe and sound business operations, quality services as well as desirable profitability", but this has not been reached to date.

To support our claim that partial governance reforms are unlikely to prevent accumulation of financial strains in major banks, we first review the reform achievements of the last few years, focusing particularly on the regulatory reform implemented by China Banking Regulatory Commission (CBRC) since 2003. In the subsequent section, we review financial restructuring and governance reforms of three major Chinese banks now listed on the Hong Kong Stock Exchange (HKSE). The third section discusses the "market test" of reformed banks by reviewing their stock performance, ratings and views of financial analysts. We address the apparent paradox that investors are keen to buy banks stocks despite being aware of prevailing weaknesses and long term uncertainties. We find an explanation in the credibility of the state guarantee behind the three major banks that are too-big-to-fail. In the concluding section we review the departures of the current reform strategy from recommendations based on international standards. We propose possible interpretation of these departures that could serve as basis for further research.

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[4] In banker's jargon good loan, i.e. loan that is being repaid as planned and there are no reasons to expect that this would change in the relevant future period, is called a "performing asset". Loan that is not being repaid according to the contract or where there are grounds to expect that the borrower will not be able to honor forthcoming repayments in time, is known as "non-performing assets" (NPLs).

[5] See Girardin (1997) for the analysis of the early 1990s credit boom and policies containing it.

Regulatory reforms in banking sector

Prior to reform period there was the soviet-style monobank system in China. The first major banking reform was implemented in 1984, when the bulk of the real sector financing was shifted from the state budget to the banking sector. At the same time, state enterprises were allowed to retain after tax profits, which triggered rapid growth of savings channeled to the banking system. This phenomenon continues to date as the savings rate exceeds 50 percent. Still in 1984, the People's Bank of China (PBOC) - the central bank - and the four largest state-owned commercial banks (SOBs) were formally separated[6].

It took another decade before the two-tier banking system was given the legal underpinning[7]. In 1995 the Commercial Bank Law was promulgated to provide formal legal basis for transforming specialized state banks into state-owned commercial banks. In an effort to shift the state-directed lending out of the commercial banks, three policy banks were created[8]. New laws aspired to improve lending standards and making bank management accountable for bank performance. New loan classification standards - more in line with international rules - were gradually introduced, loan officers were made individually responsible for new NPLs, and SOB's Chairmen became accountable for achieving targets set up by the government. The new banking rules also facilitated a gradual shift from credit plans to credit allocation based on asset and liabilities management. To support the restructuring effort the PBOC has strengthened balance sheets of the largest banks by capital injection of RMB 270 billion (USD 33 bn) and by removal of RMB 1.4 trillion (USD 170 bn) worth of pre-1996 non-performing loans. The SOBs were supposed to be responsible for dealing with NPL incurred after 1996 from their own resources.

[6] The Big Four are Agricultural Bank of China (ABC), Industrial and Commercial Bank of China (ICBC), Bank of China (BOC) and China Construction Bank (CCB). The term Big Three used in this paper refers to ICBC, CCB and BOC that have already been listed on the Hong Kong Stock Exchange.

[7] Until then the banking sector was operating on the basis of the Interim Banking Control Regulations of the People's Republic of China promulgated by the State Council in 1986.

[8] The three policy banks are primarily responsible for raising funding for large infrastructure projects.

Lessons form the East Asian financial crisis gave new impetus to banking reforms[9]. Although China was protected from the worst impact of the crisis by functioning system of capital controls, policy-makers in Beijing understood that poorly governed financial sector is a major threat to economic development. Reforms between 1998 and 2002 were characterized by “throwing money at the problem”, but had little effect on the bank governance and risk management. The OECD analysis at the time concluded that the "financial quality of SOBs, is rather poor, with low earnings, inadequate capital, and high levels of non-performing assets. [They] would probably be insolvent if their balance sheets were subjected to careful scrutiny using strict loan classification standards… [Their] governance system … is not well suited to operating as profit-seeking institutions ... The management of the banks is not conducted by professional managers with a clear mandate to return value to shareholders, but by government officials whose goal is to achieve a balance of economic and non-economic objectives." (OECD 2005: 382).

In 2002 the ‘National Financial Work Conference’ of the State Council devised new blueprint for deeper reforms and created the CBRC to implement them. The CBRC has adopted banking reform based on the concept of "grasping both ends and facilitating development of the majority." The "first end" refers to reforms of the largest state owned banks that control over 50 percent of banking assets. The "second end" is about reforms of over 50 thousand rural credit cooperatives that account for some 10 percent of banking assets. The remaining "majority" consists of 120 joint-stock and city commercial banks. The majority group is expected to increase as foreign banks move into Chinese market following the 2006 phase out of all entry restrictions in accordance with the WTO agreement. Henceforth, we will focus on the reform achievements of the largest banks.

The CBRC is headed by Liu Mingkang, former deputy governor of the PBOC and president of the Bank of China, who has earned reformist credentials with the foreign observers (EIU 2006: 8). His principal challenge is to develop enforceable regulatory and supervisory framework that would change incentives of bankers towards prudent banking. This is no easy task in China,

[9] The key lesson from East Asian crisis is that without adequate governance and regulatory structure banking sectors remain prone to collapse, if exposed to macroeconomic shocks (such abrupt change in capital flows).

where the four largest banks employ 1.4 million people who work in nearly 70,000 branches. The CBRC itself has 333 offices, 1,753 local supervisory agencies and employs staff of over 23,000, which turns internal capacity building into a major challenge in itself.

In practical terms, the CBRC has focused on establishing itself as an organization, training its staff, creating new regulatory framework compliant with WTO, forcing more timely and reliable disclosure of information and, most importantly, pushing ahead pilot reforms of the four largest banks. It has also participated in the government attempt to cool off overheated sectors of Chinese economy and tried to reduce extend of fraud and illegal use of banking funds (CBRC 2007). CBRC's reform blueprint is build around international standards and best practices. Namely regulatory reform is guided by (i) the Core Principles for Effective Banking Supervision, (ii) a combination of Basel I and Basel II capital accords and (iii) international practices in loan loss classification rules. In the rest of this section, we will review the current status of implementation of these three sets of rules.

The Core Principles agreed upon by the BIS committee in 2006 serve as a global benchmark for banking regulation and supervision practices. IMF and World Bank rely on them in their Financial Sector Assessment Program (FSAP)[10]. Brehm and Macht (2005) review in very fine detail the compliance with these standards relying on the IMF methodology. They conclude that the regulatory framework has achieved high degree of compliance with the Basel I Core Principles (see the summary table). Moreover, China has also introduced some features of Basel II Accord thus her de iure framework is more advanced than in many other countries including developed ones[11]. However, the Chinese legal framework departs from international benchmarks in two important ways. First, the CBRC is not provided with sufficient autonomy and remains under the control of the State Council and the Chinese Communist Party. This control is exercised primarily though their tight control of personnel policy of CBRC. Secondly, the quality of the financial

[10]China is one of the few countries where IMF have not yet conducted the FSAP survey.

[11] China has introduced Pillars 2 and 3 of Basel II framework that cover rules on supervisory review process and on provisions facilitating market discipline over banks respectively. For the Pillar I, which covers methods for the calculation of credit, operational and market risks China plans to stay within Basel I framework for some time after developed countries switch to Basel II. This mixture of Basel I and II principles is sometimes referred to as Basel 1.5.

information remains too uncertain, because the supporting institutions such as good accounting and auditing standards are absent.

Exhibit 1 Weaknesses in de iure implementation of Core Principles

Core principles	**Weaknesses**
Clear objectives, autonomy, powers and resources (Principle 1)	Autonomy of CBRC is restricted because the State Council can overrule its decisions and exert undue pressure on CBRC through its audit and supervisory bodies. The Communist Party retains control over the personnel decisions including recruitment and dismissal.
Licensing and ownership changes, prudential requirements and ongoing supervision (Principles 2 to 21)	Full formal compliance.
Information requirements (Principle 21)	In structural terms there is full formal compliance, but the Chinese legal framework ignores the issue of quality of information disclosure. The accounting and auditing framework remains weak, undermining the trustworthiness of financial information.
Remedial measures and exit; Cross-border banking (Principles 22 to 25)	Full formal compliance.

Source: Brehm, Macht (2005: 175 – 177 and Appendix 1)

Relatively high degree of compliance with the Core Principles does not necessarily mean that they are enforced. As is demonstrated by the experience of many transitions and developing countries for the regulatory reform to succeed the new structure of incentives must be enforceable and enforced (Pistor et al. 2003, World Bank 2003). The CBRC is making progress in enforcement of new regulations (see Exhibit 2), although given this size, scope and complexity of the sector, cases and corrective actions affect only the tip of an iceberg (Chow 2006). On the other hand, recent disciplinary actions included some high profile cases (see end of this section).

Exhibit 2 Disciplinary actions of CBRC

	2003	**2004**	**2005**	**2006**
Number of Banking Institutions Examined	61,702	74,911	68,360	69,179
Amount of Penalties on Illegal Transactions (RMB 100 million)	1,768	5,840	7,671	10,147

Number of Banking Entities which Received Penalties on rule-breaking activities	1,512	2,202	1,205	1,104
Number of Senior Managerial Personnel with Qualifications Revoked	257	244	325	243
Average Institutional Coverage Ratio of On-Site Examinations (%)	27.8	36.0	34.0	35.0

Source: CBRC (2007: 147)

Numerous reports point out two key challenges to better enforcement of the new rules. The first is the sheer size of the country. Whereas, branches of major banks and of CBRC in the key economic centers are reasonably well suited to enforce new rules and struggle against the powerful political interests, on the provincial level there is much less progress (Chu et al. 2006, Davies 2006, Tang 2007). It proves very difficult to overcome the long term legacies of decentralization. The second challenge is that of human capital. There are very few experienced bankers and regulators alike thus they need to be trained in large number which will take some time (Chu et al. 2006a, Hope and Hu 2006, Brean 2007).

The Basel Capital Accord is the second package of international standards now being implemented in China. It defines several categories of assets and assigns them risk weights, which are then used to calculate the necessary volume of capital. The capital requirement serves four key purposes (i) creates incentives for bank shareholders to behave prudently to avoid loss of their capital, (ii) confines the expansion of bank lending within the limits of its capital base and (iii) facilitates regulatory convergence that reduces distortions in international banking competition.

The risk weighting rules in China broadly comply with the Basel I requirements, although Brehm and Macht (2005) identify two important departures. The risk weight assigned to credits to domestic banks is only 20 percent, whereas by the Basel I standards this should be 100 percent[12]. This puts domestic banks on par with OECD banks to which Basel rule also assign 20

[12] The higher the likelihood of default of the borrower, the higher risk weight should be assigned to given loan and thus more capital is required to protect bank in the event of default. By assigning the same risk weight to OECD and domestic banks, the CBRC effectively suggests that they have comparable risk profiles.

percent risk weight. The second departure is that Chinese rules assign zero risk weight on loans to the state-run asset management companies (AMCs). These took over non-performing assets from major banks at their nominal value and are thus expected to generate losses of 70 to 90 percent (Chu et al. 2006b: 3). The zero percent risk weight would be reasonable if these AMCs were backed by explicit state guarantee, which they are not.

The risk weighting system is also biased in favor of lending to the central government. It assigns zero risk weight to claim on Chinese government and 50 percent weight to claims on public sector entities invested by the central government[13]. Foreign denominated claims on central government also got zero risk weight, which is contrary to the Basel rules (Brehm, Macht 2005: 178). These departures from the Basel Accord make the Chinese Capital Asset Ratios (CAR) less internationally comparable. Moreover, they make it somewhat easier to achieve the required 8 percent benchmark.

The third important aspect of the regulatory framework is the loan classification system. This refers to the process that banks use to review quality of their loan portfolios and assign loans to categories or grades based on the perceived risk and other relevant characteristics of loans. The system should induce banks to take remedial actions in case of deterioration in the credit quality of a loan. There are no explicit international rules on loan classifications comparable to Core Standards of Banking Supervision or Basel Capital Accord discussed above. However, there is an ongoing convergence of classification rules that provides some internationally accepted benchmarks (World Bank 2003, Barth, Caprio, Levine 2006).

Loan classification rules are the most important component of the risk management framework and the crux of banking activity after the loan has been disbursed. The loan classification has profound influence over the financial stability of the bank, because it includes fundamental decision: Is the loan good or bad? If bad loans are classified as good then bank management might not be aware that there is a problems threatening the bank stability until they cumulate

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[13] This contrasts with the 100% risk weight assigned to claims on the public sector entities invested by the local government. The high risk weight makes this lending more expensive as it must be fully backed by bank capital. The rule shifts resources to central level and makes local bank branches less able to bend into local pressure for loans.

beyond manageable proportions. If good loan is classified as bad, then the bank needs to take costly remedial action, which reduces bank profits and growth potential.

Bankers face conflicting incentives in the good loan/ bad loan decision, therefore regulatory rules ought to strengthen incentives for prudent behavior. Bankers should recognize potential losses early on and cover them with sufficient provisions and reserves. This prevents accumulation of losses that could threaten bank stability. At the same time, it needs to be recognized that classification decisions are taken under uncertainty and thus no rules may cover all risks. This is especially the case for emerging economies such as China, where economic, political and legal uncertainties are generally higher than in more developed countries.

The high stakes on the good loan/bad loan decision help to explain why there are no straightforward international standards. Such decision can not be made out of the context of the real economy. The particularities of the institutional framework can not be ignored[14], if the good loan/bad loan decision is to reflect the underlying value of scarce resources. For example, if the bankruptcy procedures are well structured and enforceable in a given country, bankers will have stronger incentive to classify troubled loans as bad and seek foreclosure of the collateral. If bankruptcies do not work well, bankers will have incentives to keep the loan in the "good" box as long as possible, and try to negotiate some solution with the borrower that would not entail the malfunctioning bankruptcy procedure.

The need for country-specific features does not prevent meaningful international comparisons of classification standards. If the risk profile of the given economy is higher than in the benchmark case, then more stringent classification rules should be expected. Given that the three major banks are listed at Hong Kong Stock Exchange, comparison of the mainland rules with Hong Kong rules is the most natural. We should expect that mainland rules will be stricter as banking business is more risky in China proper than in Hong Kong SAR.

In both cases the banking sector regulator has the right to set classification rules. They use the same five category classification – pass, special mention, substandard, doubtful and loss. Both jurisdictions rely on largely comparable classification rules and provisioning requirements. Loans

[14] Institutional framework is mentioned in the sense of North's (1990) formal and informal rules of the game including their enforcement characteristics.

that are 3 months overdue are classified as substandard and require 25 percent provisioning. After 6 months they turn doubtful and banks have to provision them up to 75 percent of outstanding value. Losses, of course, require 100 provisioning[15].

China has recently aligned the tax treatment of provisions more with the Hong Kong practice. The ceilings on maximum amount of provisions that is tax deductible were abolished thus removing one major disincentive to prudent provisioning. However, China allows writing off losses only after all means of collection and legal action have been exhausted. That may postpone the recognition of losses in income statements (World Bank 2003: 32).

One important difference with potentially major impact on the prudential indicators is treatment of real estate collateral. The Hong Kong Financial Authority, along with many other bank regulators world wide, sets specific guidelines for real estate valuations, whereas CBRC only asks banks to have "adequate policies and procedures on recognition and assessment of collateral" (World Bank 2003). Such a degree of bank discretion makes it more difficult to enforce prudent valuation rules. Given the current real estate boom in China, collateral values grow fast and allow for fast credit expansion[16]. However, the real estate bubble may burst quickly and loans secured by real estate may turn into heavy losses. Even if, the real estate values are sustained, their use as collateral should be tightly regulated as it is not trivial to foreclose such a property. Banks may "evergreen" losses by reference to collateral that can not really be marketed any time soon.

Chinese bank listed in Hong Kong have published their internal criteria. They used the discretion granted to them by regulator and each of them proposed slightly different set of rules (see Lai 2007: 30 for details). Their rules are based on overdue period and also take into account other

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[15] Unlike mainland China, Hong Kong has separate, less stringent rules on secured loans, which reflects the differences in the legal infrastructure that makes seizure of collateral possible.

[16] Valuation of the real estate collateral, especially during longer boom periods, is an Achilles heel of banking sectors around the world. Banking crises in developed countries such as Japan or Sweden in 1990s had their roots in real estate boom. Overvalued real estate collateral was also one of the principal channels of manipulating the prudential bank indicators in many transition countries such as the Czech Republic or Romania.

qualitative factors such as a borrower's cash flows, financial condition, repayment history, collateral value and support from guarantors[17].

When rules stipulated by CBRC are combined with those developed by each of the Big Three, the difference in the formal loan classification framework in China and Hong Kong is relatively small. Indeed, Lai (2007:29) concludes that they are comparable despite their lack of uniformity across major banks[18]. Nevertheless, if the logic that more risky economies ought to have more stringent standards holds, then the Chinese rules fail to compensate for the extra risks of borrowers from the mainland.

The potentially more important problem is the lack of uniformity of classification rules. Different approaches of banks add to the complexity of the system and make rules more difficult to enforce. Although it can be argued that such system is close to the "internal rating" approach of Basel II, it runs contrary to the well established insight form transition and developing economies that simple rules are more credible, because they are enforceable (Barth, Caprio, Levine 2006). The higher complexity of rules only increases the demands on the regulatory capacity of CBRC, which is in short supply even by its own assessment (Tang 2007).

Although regulatory reforms of major banks closely followed recommendations of international best practice their implementation retains numerous "Chinese characteristics" that depart form the intention of the international rules. Some of these characteristics can be explained by relatively short period of reform implementation. These may disappear as the reform effort continues. However, there are other departures from international standards that reflect conscious policy choice. These include lack of regulatory independence, rules that encourage lending to project backed by the central government and lack of uniformity in classification and

[17] The BoC and CCB report in compliance with International Financial Reporting Standards (IFRS39).

[18] Fitch, the rating agency, points out that" many of the banks … are in the process of introducing more refined internal systems for classifying both customers and loans. … Nevertheless, while current initiatives are certainly positive, [Fitch] would highlight that numerous external factors continue to complicate the transition toward improved management of credit risk, including poor borrower disclosure and accounting, the lack of a deep and experienced pool of credit officers, and nascent credit bureaus. As a result, actual progress will likely be protracted and slower than expected or advertised" (2006:6).

collateral valuation rules. International practices are thus implemented in an incomplete, selective manner that undermines their internal coherence[19]. This reform design preserves some important loopholes, and creates other unintended incentives, which increase the risk of accumulation of undisclosed losses that may ultimately require yet another bail out of the Big Three.

The above departures from international standards and practices are compounded by other characteristic of Chinese political economy that slow down the spread of reforms and convergence with global norms.

The size of the banking and regulatory hierarchies combined with the deeply rooted tradition of decentralization presents formidable challenge to reforms that is unique to China. In no other economy banks employ 1.5 million people in 31 highly decentralized and fragmented provincial economies (see Huang 2003). Traditionally large banks' branches were functioning as semi-independent local banks with their regulators under local political control (Quian 2003). This legacy is proving very durable and slows down the spread of new rules down to the last bank branch and CBRC bureau.

The lack of alternatives to SOB's credits, such as FDI, in backward provinces further complicates diffusion of modern banking practices. Local government officials are reluctant to cede the control over bank branches as it allows them to keep benefits of reckless lending locally and shift losses to the central government. Shih (2004b) and Heilman (2005a, 2005b) analyze the complex political coalitions that protect these locally beneficial arrangements. They point out that the selective implementation of international standards strengthened the central control, but many non standard practices prevail. One of them is the issuance of local government "guarantees" for certain projects, which are illegal, but local bank branches often accept them (Marshall et al. 2005: 5).

The general problem of absence of rule of law in China has repercussions for the banking reform too. The legal system remains fuzzy, slow, ineffective and uncertain. It lacks of elementary

[19] Currently, there is no plan address these departures from the international standards, although they are well known in China and abroad. This suggests that they are indeed part of the reform blueprint rather than unintended omissions.

transparency and corruption is pervasive. This undermines contractual relationships of banks and firms and hurts especially private enterprises that are the most dynamic source of economic growth (OECD 2005). Poor legal system also explains why investments and loans are often channeled to the real sector via Hong Kong dressed up as FDI that enjoy better protection (Huang 2003). This increases risks that credits will be "lost" in a web of complex arrangements, adds to transaction costs and increases demands on bank's monitoring capacity.

Corruption still plays a significant role in bank lending in China (Marshall et al. 2005: 6). Especially, small private companies that have poor access to credits from state banks, have a lot to gain by bribing loan officers. Prevalence of this phenomenon is confirmed by a sustained array of high profile corruption cases[20]. In 2006, the CBRC launched anti-corruption initiative aimed at raising awareness of illegal practices and cracking down on corruption. It forced all banks to conduct self-examinations in which 1,124 improper transactions involving 570 people and a total of RMB 110 million (USD 13 million) were discovered. Additional cases were identified during on-site supervisions. Given the reports on extensiveness of corruption in China these cases are perhaps little more than a tip of a glacier (Chow 2006). However, CBRC's attention to the problem makes corrupt behavior more risky, thus gradually changing incentives of ordinary bank employees.

Last but not least of the important "Chinese characteristics" is prevailing price regulation of many important inputs. OECD (2005, Table 1.13), for example, reported that prices of 10 percent of transaction volume in the productive sector are fixed by the state and further 3 percent are "guided". This may seem little compared to 100% price regulation 25 years ago or 54% 12 years ago, but the distortion is highly relevant in some important sectors. For example, regulated prices of energies create incentives for lending into energy-intensive sectors that are

[20] For example, the official newspaper People's Daily run a report on high profile corruption in banks involving top level officials from the Finance department of Ministry of Finance and former president of one of the Big Three banks ("Another top Chinese finance official imprisoned for bribery", March 13, 2007).

threatened by excess capacity and are likely to have problems repaying loans even under generally favorable economic conditions[21].

Governance reforms of the Big Three

Meticulous focus on reforms of individual SOBs is the single most visible change in the banking reform strategy since 2002. The CBRC was given powers that go well beyond the hands-off banking regulation. It may intervene on behalf of the state, which remains the majority owner of banks. In 2004, the CBRC issued Guidelines on Corporate Governance Reforms and Supervision of Bank of China and Construction Bank of China (henceforth Pilot Guidelines). This document outlined the reform strategy and defined performance goals and deadlines to be achieved. Initially, it was tested on BOC and CCB; the ICBC has followed the same path once it has proven feasible. The ABC is striving to follow, but associated difficulties have proved insurmountable to date.

Pilot Guidelines have defined the reform goal as: "to build within three years … modern and internationally competitive joint-stock commercial banks with adequate capital, strict internal controls, safe and sound business operations, quality services and desirable profitability". To this end, the CBRC defined seven quantitative performance criteria based on the averages of the world's top 100 banks[22]. Again, international standards and benchmarks provided as much inspiration for the governance reform as they did for regulatory reforms.

Banks were also given several governance targets. They were to build governance structure of a joint-stock company, comprising of shareholders meeting, board of directors, supervisory board

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[21] Moreover, these sectors are responsible for lion's share of environmental damage that is recognized as increasingly important problem requiring policy action. This may include shut offs of industrial facilities in highly polluted locations with consequent inability of affected enterprises to repay their loans.

[22] The seven performance criteria published in March 2004 are as follows (i) net return on total assets shall be 0.6 percent in the second year after the completion of financial restructuring and up to good international standard within three years, (ii) net return on equity shall achieve 11 percent in the second year after the completion of financial restructuring and increase to over 13 percent gradually in the subsequent years, (iii) cost to revenue ratio shall be controlled within 35 to 45 percent starting from the second year of financial restructuring, (iv) non-performing loan ratio shall be under 5 percent, (v) capital adequacy ratio shall be over 8 percent, (vi) concentration risk of facilities shall be 10 or lower, and (vii) coverage of NPL provisions shall be 60 or higher and increase to 100 percent within five years.

and senior management and clarify decision-making powers of all these bodies. These bodies were to design a development strategy the sole goal of which was to be maximization of profitability. The organizational restructuring also required banks to create necessary systems of internal control and risk management that would cover all "Basel 1.5" components.

The single most important obstacle on the banking reform path was a gargantuan proportion of non-performing assets. After several rounds of pre-2002 bail outs NPL ratios were reduced, but still between 15 and 25 percent of loans in major banks' portfolio was not to be repaid (see Exhibit 3)[23]. There was no plausible scenario that Chinese banks could "grow out" of these losses without external financial assistance. Further state-orchestrated bailouts were necessary. This time, however, the formal conditions attached to bail out were well defined in the Pilot Guidelines and CBRC was is position to enforce them much more than similar, but vague conditions attached to pre-2002 bailout packages.

Exhibit 3: NPL ratios of the Big Three

	2002	2003	2004	2005	2006
ICBC	25.34	21.24	18.99	4.69	3.90
BOC	23.37	15.92	5.12	4.90	4.00
CCB	15.05	9.25	3.92	3.84	3.40

Sources: Annual Reports of banks and Fitch Ratings reports

Equivalent of 22 percent of 2004 GDP has been spent on bailouts of the three largest banks (OECD 2005:43 and author's calculation) since 1998, when the East Asian crises put banking reforms high on the agenda. Over 1.3 trillion RMB (about USD 156 bn or 10% of GDP) was spent on bailouts associated with restructuring of the Big Three derived from Pilot Guidelines. A lot more is to come during the restructuring of the Agricultural Bank of China[24].

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[23] These are official figures; observers speculated that if internationally comparable classification was applied the proportion of NPLs would between 40 to 50 percent. Wu (2003) has reviewed estimates of academics as well as financial practitioners of the extent of the NPL problems in the Chinese banking sector. These figures ranged from 20 to 75 percent of annual GDP in 2000.

[24] The preliminary estimate of costs of ABC clean up stand at USD 70 bn ("Central bank vice-governor to be appointed head of ABC", Xinhua, July 16). Further costs will be associated with bail outs of development banks created to take over policy lending from the Big Four that now seem to enter the restructuring path of pilot banks ("Development Bank in line for US$20bn boost", South China Morning Post, August 7, 2007).

The available estimates put the total expected costs of Big Four bailouts at about 30 percent of GDP (Ma 2007)[25]. This estimate is somewhat higher than fiscal costs of bank restructuring in small European economies in transition. In these cases, the costs ranged from 1 percent in Estonia to 27 percent of GDP in Bulgaria, with average around 12 percent (Tang et al. 2000). Indeed, if the bill for bank restructuring stays at 30 percent, the Chinese case would be one of the ten most expensive cases of bank insolvency worldwide since 1975 (Caprio and Klingebiel 1996).

Exhibit 4: Estimates of capital injections into Big Three since 1998

Actions undertaken		Government borrowing	Government assets	AMC borrowing	Total financing provided
		RMB billion			
Capital injection	1998	270	0	0	270
Sale of bad loans	1999	0	0	1400	1400
Capital injection: CBC, BOC	2003	0	373	0	373
Sale of bad loans by CBC and BOC	2004	0	0	128	128
Capital injection ICBC	2005	0	124	0	124
ICBC NPL disposal	2005	0	0	680	680
Total of above		270	497	2208	2975
Total (% of 2004 GDP)		2%	4%	16%	22%

Note: The update of OECD figures measures immediate costs to AMC's which had to borrow 100% of nominal value of the ICBC NPLs. The final fiscal costs will be lower as some value of NPLs will be recovered. To date AMC's recovery rates are between 10 and 20 percent, although Chu et al. (2006:3) expect recovery rates to rise to around 30 percent as sales proceed to less seasoned NPLs (see also Ma 2007 for detailed review of fiscal costs of Big Three bail outs) .

[25] During their peak in late 1990s the median estimate of NPLs to GDP was about 40 to 50 percent of GDP. Given the high GDP growth and low returns on NPL sales, the 30 percent estimate seems to be a reasonable upper bound. However, this rests on the assumption that there will be no further bail outs necessary.

Source: OECD (2005:43) and updated by ICBC information from CEQ (2006: 11).

Low NPL figures for the three reformed banks should indicate that China has successfully dealt with the stock of bad loans. However, two important issues are still intensively disputed – the reliability of prudential indicators and their sustainability over the medium and long term. The first issue questions whether the stock of NPLs was really removed in full; the second questions whether the flow of new NPLs has been terminated.

The reliability of Chinese economic indicators in general and banking indicators in particular is questioned in a heated debate (see OECD 2005, Wu 2003, EIU 2006). Financial statements of the Big Three are audited by reputable global auditors[26], but rating agencies point out to ongoing problems in the Chinese accounting system that auditors are obliged to respect (Chu et al. 2006: 6). The loopholes in classification rules, reviewed in previous section, also increase room for creative financial reporting, especially when it comes to real estate collateral and projects backed by the central government. It is, however, impossible to estimate quantitatively the cumulative effect of these loopholes on the reliability of prudential ratios[27].

The credibility of financial statements is also undermined by anecdotal controversies. For example, in April 2006 the Ernst & Young - an auditor of the largest bank in China – has released a Global Non-performing Loan Report, arguing that the Big Four banks have about USD 358 bn of NPLs on their books (Ernst & Young 2006: 14). This contrasted with the official figure of USD 133 bn (CBRC 2006). After the protests of Chinese officials, the Ernst & Young has withdrawn the report explaining that it did not undergo "normal internal review and approval process before it was released … [and] it contains errors"[28]. Fitch, the rating agency also stated in its annual report on Chinese banks that it is “cautious with regard to the asset quality of Chinese banks,

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[26] The ICBC, BOC and CCB are audited by Ernst&Young, PriceWaterhouseCoopers and KPMG respectively.

[27] The experience with initial bank restructuring in other transition countries is such that low NPL ratio after bail outs did not last long unless banks were privatized to foreign strategic owners (Berglof and Bolton 2002, Bokros 2000, Kudrna et al. 2002, Keren, Ofer 2003).

[28] “Ernst & Young Withdraws Nonperforming Loan Report”. Press release of Ernst & Young dated May 12, 2006. The withdrawn report has cited similar analyses from USB (investment bank) and McKinsey&Company (management consultancy) in support of its conclusion. Moreover, Ernst&Young has published the same report regularly at least since 2002 and their methodology and findings were not questioned before.

given ongoing issues with accounting and disclosure (for both banks and borrowers)" (Chu et al. 2006: 4).

Sustainability of the low NPL ratio is the more important issue. Continued economic growth, improvement in profitability of the largest state-owned enterprises, and the diversification into fee-based banking services currently reduce the pressure on prudential indicators (Lai 2007, Chan et al. 2007).[29] However, there are identifiable threats that may gradually undermine banks' financial stability despite the supportive economic environment. There is a consensus that the two most immediate threats are: (i) the speed in which high level of "special mention" loans turns into non-performing loans and (ii) exposure of major banks to overheated sectors (Podpiera 2006:11, IMF 2006: 3, Chang et al. 2006).

The Big Three's proportion of "special mention" loans stood between 8 and 11 percent in mid 2006. These are loans where borrower shows some weakness in repayment, but they are not yet long overdue. Should they be downgraded further, they would turn into earning risk and require provisions (special mention loans require only 2% provisioning, whereas non-performing loans 25 to 100 percent). Chan et al. (2007: 35) argue that the high level of special mention loans should not matter because the figure is inflated by a prudent practice of including all loans to enterprises with less than three years of financial statements in this category. The benign view is also supported by the fact that only about 6% of special mention loans turned into sub-standard loans in 2006. Lai (2007: 27) runs a sensitivity analysis showing that this rate of downgrades has immaterial impact on bottom line and stability indicators[30]. However, rating agency analysts are again more skeptical than brokers. They take the view that in medium term it may be 50 percent of the special mention loans that turns nonperforming. If that is the case the Net NPLs/Equity ratios for major banks would rise from 14 percent to 69 percent (Chu et al.

[29] The significance of diversification for further prospects of large banks is hotly debated. Some analysts argue that retail would be the source of stability and profitability (Lai 2007), whereas others point out that the share of retail loans is oscillating within 15 to 20 percent of total loans thus the Big Three would remain engaged in much riskier corporate lending (CEQ 2006).

[30] Her sensitivity analysis shows that if 5% of special mention loans are downgraded to NPLs, the Big Three 2006 earnings can reduce by 10 to 13%, ROE by 1.5-1.7 and CAR by 0.1 percentage points. She argues that unless there is an economy-wide slowdown, the net 5% rate of special mention loan downgrades is reasonable, because there are some upgrades too.

2006: 5). This indicates that major banks are not yet adequately capitalized given the existing level of provisioning and NPLs.

The high exposure to overheated sectors is also considered benign unless there is an unexpected economic slowdown. Lai (2007: 32) argues that in all cases of macroeconomic tightening during the past 5 years the negative impact on asset quality was limited to overheated sectors in some regions and had immaterial impact on the overall asset portfolio. This expectation is also supported by a successful pressure of CBRC aimed at reducing lending to overheated sectors, which includes focused on-site inspections on the branch level (Chan et al. 2007:8, CBRC 2004, 2006).[31]

The debate on the reliability and sustainability of quantitative financial indicators is clearly inconclusive[32]. None of the analysts disputes major improvements and they all agree that any economic slowdown would trigger rapid rise in NPLs. However, when unexpected macroeconomic slowdown is assumed away, their evaluations diverge as there is no consensus regarding the future trend of financial stability indicators. Chinese financial data and processes that generate them are surrounded by high degree of uncertainty, which prevents any attempts for credible predictions. Moreover, there is no past track record that would allow for any meaningful short term extrapolation.

However, the question of sustainability of prudency ratios can also be posed on the level of institutional environment and governance structures[33]. Instead of trying to build short-term predictions on the basis of quantitative model, we may adopt more qualitative approach and ask whether the governance and risk management structures of the Big Three warrant prudent

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[31] The Economist (October 27, 2005) quotes Western independent director who summarized the CBRC approach to supervision as: "at every board meeting, the CBRC guy is right there taking notes and pounding the table."

[32] The only conclusion might be that brokers are more optimistic (Lai 2007, Chan et al. 2007) than rating analysts (Fitch 2006) and IMF (IMF 2006, Podpiera 2006), which says nothing more than that incentives faced by different analysts matter.

[33] In line with the Williamson's (2000:597) argument about levels of social analysis, it is asserted that the institutional environment (legal and regulatory rules) shapes constraints on the bank governance, which in turn shapes incentives that bank managers and employees face when making decisions about such parameters as prices, quantities and information disclosure. Therefore, if institutional environment and governance arrangements establish incentives for, for example, proper construction and reporting of prudential ratios, then it is reasonable to assume that credible figures will be reported.

decision making that would make low NPL ratios credible and sustainable. The analysis of governance structures may provide important insights, which are not yet reflected in financial indicators, but which would affect them profoundly in medium and long term. We may address questions like the following with the analysis of governance structures. Have governance structures changed to guarantee prudent credit decisions and thus sustainability of low levels of NPLs? Do banks have the system of risk management and internal controls that would prevent approval of weak credit proposals? Do they have systems that would prevent unrecognized accumulation of NPLs? Answers to these questions depend to a large extend on incentives of individual bankers that in turn are influenced by prevailing regulatory and governance arrangements.

The governance reform, outlined by Pilot Guidelines, started by organizational restructuring. Banks were corporatized, usual joint-stock company governance structures were created and different state organizations were assigned to exercise shareholders' rights at annual meetings (see Exhibit 5). Directors on the supervisory board and board of directors were appointed largely from among public servants and past bank employees (OECD 2005), although some non-executive directors as well as independent directors of international standing were invited too (see Exhibit 6). Bank boards have created plentiful committees that are recommended as best practice.[34]

Exhibit 5: Post-IPO shareholders of the Big Three

Bank	Chinese state shareholders, %	Non-state shareholders, %
ICBC	Ministry of Finance 35.3 Central SAFE Inv 35.3 Social Security Fund: 5.3	Goldman Sachs: 5.1 Allianz: 2.2 Credit Suisse 6.87 Merrill Lynch 6.87 American Express: 0.8
BOC	Central Huijin Investment: 69,0 Social Security Fund: 4.6	Royal Bank of Scotland China: 8.5 UBS AG: 1.4 Temasek: 4.8 Asian Development Bank: 0.2
CCB	China SAFE Investments: 74.3	Bank of America Corp 8.52

[34] These include audit committee, strategy committee, nomination and compensation committee, risk management committee and related party transaction committee.

		Temasek Holdings 5.88

Source: Lai (2007)

The two most important components of the governance reforms, besides creating elementary governance structures, were (i) the invitation of the foreign strategic investors and (ii) subjecting major banks to financial market oversight following their IPOs on the mainland and in Hong Kong. Foreign strategic investors were invited to buy minority stakes prior to H-shares IPOs of the Big Three. However, their role is more of portfolio investors than strategic ones. None of them took any managerial responsibility and their role in governance is limited to appointment of an independent director on bank's board.

Exhibit 6: Board composition of the Big Three

Bank	Independent directors	Non-executive directors	Executive directors
ICBC	3	7	4
BOC	4	8	4
CCB	5	7	4

Source: Annual Reports for 2006

The key role of strategic investors was to demonstrate that the Big Three provide credible investment opportunity. They did so by investing more than USD 14 bn. This has undoubtedly contributed towards enormous success of the Big Three IPOs. Initial Public Offerings of all three banks were heavily oversubscribed by institutional as well as individual investors. Funds that were eventually raised exceed initial expectations by a huge margin.[35] These IPOs also broke number of financial records, with the ICBC IPO being the largest ever worldwide[36]. All three banks jumped from obscurity to top lists of major banks in matter of days[37].

[35] For example, a year prior to the IPO IMF expected ICBC to raise about USD 10 bn, but the final amount was twice as much (IMF 2006: 39).

[36] Although the success is undisputable it had its price. For example, following its IPO the ICBC had been valued USD 130 bn. This needs to be compared to the total amount of capital injections and bail outs handed out to ICBC in last eight years, which totaled at USD 162 bn (CEQ 2006: 11).

[37] ICBC shares rose by 15% on the day of the IPO and it became 5th largest bank by market capitalization in the world (The Deal, October 30, 2006). By August 2007, it became the largest bank worldwide, when its market capitalization exceeded that of Citibank; currently it is the fourth largest publicly listed company worldwide (SinoCast, August 10, 2007).

Exhibit 7 Big Three IPOs

	Funds raised in IPO (USD bn) (both H and A markets)	Start of trading at Hong Kong Stock Exchange
ICBC	21.9	October 26, 2006
BOC	9.7	June 1, 2006
CCB	8.0	October 27, 2005

Source: Financial Times and Bloomberg

The pre-IPO investors generated exceptional returns on their investments. The unrealized annual gains from their investment on the day of IPO exceeded 200 percent (see Exhibit 8). However, strategic investors may not sell their shares until 3 years after the initial investment. This gives them at least short term incentive to work towards stability and profitability of the Big Three banks. At mid point, their investment is performing rather well as annualized returns at June 2007 stock prices are still highly exceptional. Even, if banks only kept current market valuation until the time when the lock-in on strategic investor's shares expires (3 years after the original investment), returns on investment would remain high.

High returns of strategic investors are a consequence of high market valuation and relatively low purchasing price. Strategic investors bought shares at 1.1 to 1.2 ratio of their book value, which CBRC had to defend as not selling banks too cheap[38]. Today their shares are traded at around triple the book value, which is twice the usual ratio for Western blue chip banks.

Exhibit 8: Unrealized gains of strategic investors

	Dates		Estimated prices per share (HK$)			Estimate of annualized return of strategic investors		
Bank	Investor entry	IPO	Investors on entry	IPO	Jun-07	IPO	Jun-07	Sale date at Jun-07 price
ICBC	Apr-06	Oct-06	1.22	3.05	4.34	526%	195%	52%
BOC	Aug-05	Jun-06	1.14	2.95	3.95	215%	92%	39%
CCB	Jun-05	Oct-05	1.22	2.38	5.5	522%	109%	64%

[38] "China regulator defends bank sales to foreigners", Financial Times, December 5 2005.

Note: The estimates are based on publicly available data that do not include all details of the deal structure and timing. Calculations are based on exchange rate of 1 USD = 7.8 Hong Kong dollars. The "Sale date at Jun-07 price" column indicates the estimated annualized return at the date when strategic investors may sell their shares (generally 3 years after the purchase) assuming the price would be the same as on June 29, 2007.

Source: Author's calculation based on banks annual reports, Bloomberg.com share price data and IMF (2006: 39).

Strategic investors' role in the governance also lags behind what is typical for truly strategic involvement. They have a right to appoint or at least nominate one board member out of 14 or 16. This board member, together with several other independent board members may control about a quarter of votes. The rest remains under control of Chinese shareholders. Moreover, the bank boards are relatively new bodies that are yet to become powerful peaks of the decision-making pyramid in Chinese banks (Tang 2007, OECD 2005). To date the key decisions are still made in the nexus of the government and party bodies and boards are expected to go along formally approving these decisions.

None of the strategic investors took management responsibility. There are no representatives of strategic investors below the board level with the exception of a few consultants working on new product lines and staff training. The day to day management, credit approval, risk management and other essential functions remain firmly in hands of managers appointed and monitored by the Chinese shareholders. That is to say it is controlled by the Chinese Communist Party that determines the personnel policy of all important public institutions in China (Huang, Orr 2007, OECD 2005).

The role of strategic investors is further reduced by the fact that they were not given an opportunity to conduct proper due diligence prior to their buy-in[39]. Instead, their contracts during the pre-IPO period guaranteed them a compensation should the book value of the bank decline below certain historical value (IMF 2006). Given that bank IPOs turned enormously successful there was no use for these guarantees. However, their presence in the deal structure indicates that strategic investors lacked information on what they were buying into.

[39] Prior to their IPOs in Hong Kong the Big Three had to submit full prospectus to potential investors that included extensive disclosure of its book. However, even prospectus disclosure falls short of due diligence typically performed by strategic investors, who tend to check many important information themselves.

Exhibit 9: Role of foreign investors

Bank	Investors and their total share	Governance responsibility	Technical assistance and new product lines to be introduces	Investment safeguards
ICBC	Goldman Sachs Allianz American Express *Total 8.5 percent*	No management responsibility; Goldman Sachs to nominate one Board member.	Risk management, corporate and investment banking, credit cards (Amex), and insurance (Allianz).	Compensation only if book value declines below end-2005 level prior to the IPO.
BOC	Royal Bank of Scotland UBS Temasek *Total 14.4 percent*	No management Responsibility; RBS to nominate one Board member.	Corporate governance, risk management, and IT; wealth management, credit cards, and corporate banking (RBS); investment banking and securities (UBS).	Compensation if book value through end-2007 declines below book value at end-2004. Credit cards: 50:50 management of a business unit with RBS, when a separate joint venture is established, RBS will have 49 percent ownership.
CCB	Bank of America, Temasek *Total 14.5*	No management Responsibility; one Board member (BoA) and may nominate one more (Temasek).	BoA: Approximately 50 personnel to assist in risk management, governance, consumer banking, etc. Temasek: 1000 person/day training in treasury, SME credit, corporate business and other areas.	An adjustment of the purchase price if December 2004 financial statements are restated; credit card venture under negotiation.

Source: IMF (2006: 39) and Annual Report of the Big Three banks.

The involvement of foreign investors in core activities of Chinese banks is marginal and will not necessarily increase in future. The strict limits on foreign bank ownership remain in place. Single foreign investor is confined to 20 percent stake and all foreign investors combined to 25 percent

and there is no plan to lift these limits (CBRC 2007). Foreign investors are unlikely to be allowed to increase their stakes in near future. On the contrary, after the lock-in period on their shares expires in 2008 and 2009, they will be able to sell their shares. Contracts with some strategic investors, such as Royal Bank of Scotland (see Exhibit 9) explicitly envision spin-offs on newly developed business activities, such as credit cards, into separate joint-ventures. This may allow strategic investors to reduce their involvement in the core banking activities and cherry-pick on less risky and more profitable business in separate joint-ventures.

In short, it is a misnomer to call the strategic investors of the Big Three "strategic" given the limits they face in influencing all major factors of banking operations. They had limited access to banks' records prior to their investment; they have little say in the bank governance and they have no formal influence on the bank management and lending decisions. Their investment is essentially medium-term portfolio investment, with some technical assistance and training duties attached. Unlike in Central Europe and other emerging economies, foreign investors can not be regarded as guarantors of sound governance and risk management.

Portfolio nature of their investment also reduces the pressure on internal reforms. In Central Europe, where foreign banks are truly strategic investors, improvements in bank governance and reporting stemmed also from need to consolidate financial results of the parent financial corporation. There is no such incentive in case of the Big Three. Internal reforms are driven by the agenda of Chinese shareholders who face conflicting incentives and therefore it is bound to be very gradual at best.

The most important internal reform to date has been a separation of credit approval role from marketing and monitoring roles (Chu et al. 2006:6). This is aimed at strengthening risk management practices by reducing conflicting incentives of local bankers. Previously they were responsible for marketing of new loans as well as their approval and monitoring, with their remuneration increasingly related to volume and quality of allocated loans. This made them to expand lending and cover up problems in loan quality. The separation of marketing and approval roles reduced incentives for underreporting bad loans. At the same time, it reduced influence of local political and economic interests on the lending decisions, because credit approvals and monitoring were shifted to higher level branches or banks' headquarters in case of large loans.

Banks have also formally established the internal control and internal audit departments in order to comply with the best governance practices. These departments should oversee compliance with internal as well as external rules and report directly to the Board. Although, banks invariably report presence of these departments in their organization charts, they have yet to progress beyond training staff and clarifying their role (ICBC 2007:41, BOC 2007: 83, CCB 2007: 65). The new structure is yet to become effective force in identifying and managing risk exposures.

If strategic investors do not drive internal reforms, financial markets could. At least in principle, financial markets can exert pressure for improvements in governance and internal mechanisms, when investors sell shares of badly managed and governed firms. However, under the current circumstances it would be illusory to expect that the voice dispersed shareholders aggregated via stock exchange could exert any meaningful pressure for reform. Majority stakes in the Big Three remain state controlled and their senior managers are accountable to the State Council and Party. Incentives of managers to sustain high share price are less immediate than fulfilling policy objectives of the state and party, whatever these may be. Practices such as hostile takeovers that generally provide financial markets with some leverage over management and block holders are obviously irrelevant.

The contribution of financial markets remains limited to providing a threshold in terms of governance and transparency the Big Three had to comply with prior to their listing and sustaining pressure for transparency after the listing. The Hong Kong Stock Exchange, unlike its counterparts on the mainland, is well developed and regulated market. All listed companies have to comply with the Code of Corporate Governance Practices, which imposes extensive disclosure requirements of financial data as well as governance related information. The Big Three regularly supply all required information. Their compliance required major investments into the IT infrastructure and staff training and is an important achievement in itself. Thanks to this the Big Three are no longer furtive entities of two years ago.

Despite continued debates about reliability and sustainability of banks' prudential ratios and despite shortcoming in governance arrangements that underpin them, it is undisputable fact that they now comply with performance targets that CBRC stipulated in its Pilot Guidelines. The basic indicators of financial stability, profitability and cost structure of the Big Three compare well to the average of top 100 global banks (see Exhibit 10).

At the same time, this comparison masks an important difference. Most of the top 100 banks worldwide operate predominantly on mature developed markets, where profits as well as risk tend to be lower. Well governed banks in other emerging markets display somewhat higher prudential ratios and achieve similar profitability levels at lower economy-wide growth rate (Chu et al. 2006)[40].

Exhibit 10 Financial performance criteria for governance reform

Standard derived from performance of the global top 100 banks		ICBC	BOC	CCB
		2006 (2004 figures in brackets)		
Net return on total assets (%)	shall be 0.6 percent in the second year after the completion of financial restructuring and up to good international standard within three years	0.71 (0.65)	0.94 (0.66)	0.92 (1.31)
Net return on equity (%)	shall achieve 11 percent in the second year after the completion of financial restructuring and increase to over 13 percent gradually in the subsequent years	15.37	13.47	15.00
Cost to revenue ratio (%)	shall be controlled within 35 - 45 percent starting from the second year of financial restructuring	36.3 (34.0)	38.96 (44.35)	43.97 (46.87)
Non-performing	under 5	3.79 (21.16)	4.04 (3.92)	3.29 (3.92)

[40] Bank profitability also benefits from sustained repression of interest rates that fixes the spread between the deposit-rate ceiling and the lending-rate floor to 3.25 percent. Moreover, recent change in taxation that unifies the income tax, which was until now 15 on foreign banks and 33 percent on local banks, will provide additional short term profit boost to Big Three (Lai 2007:14).

loan ratio (%)				
Capital adequacy ratio (%)	over 8	14.05 (n.a.)	13.59 (10.04)	12.11 (11.3)
Concentration risk of facilities (%)	10 or lower	3.10	2.20	5.82
Coverage of NPL provisions (%)	60 or higher; to increase to 100 percent within five years	70.56 (3.01)	96.00 (67.88)	82.24 (61.64)

Source: CBRC (2006:39); 2004 data from bank's annual reports and Chu et al. (2006)

To summarize, targets of the governance reform were achieved it the formal sense, although implementation of governance and internal control mechanisms that underpin their reliability and sustainability is only partial and will take more time. Banks have all corporate bodies, where foreign investors can participate and they are listed on A- and H-markets. These changes are clearly supportive of continued internal reforms. On the other hand, marginal role of foreign investors in governance and management prevents the Big Three form benefiting from bank FDI in a manner comparable to other transition economies. Should there be any conflict between interests of the State Council and private shareholders, the governance structure guarantees that state interests would prevail. Apart from government's position as a majority owner, the party control over the personnel policy ensures that policy objectives will be followed.

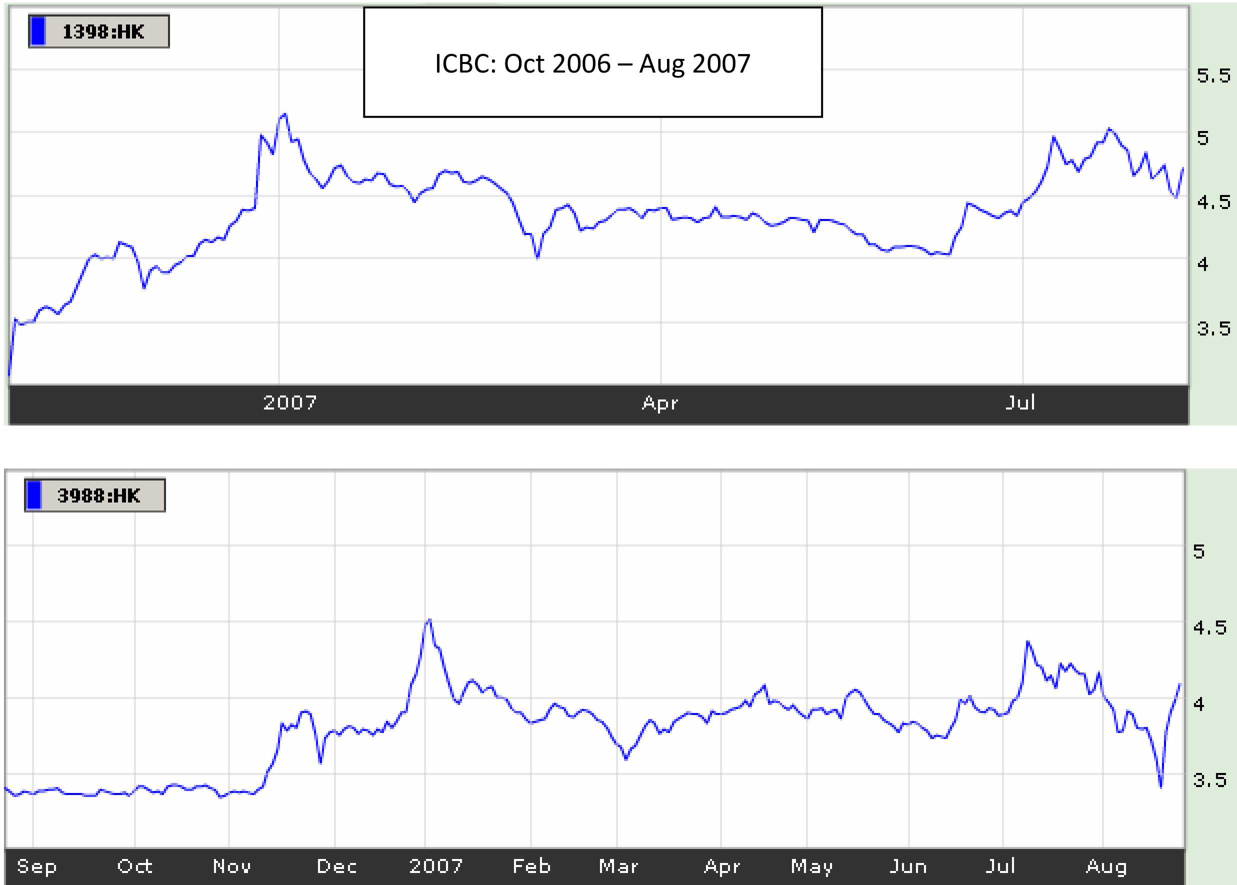
Bank performance and market perception

The Big Three banks were very well received at the Hong Kong market. Their IPOs of were heavily oversubscribed and H-share prices grew rapidly until the end of 2006, when came some correction. Prices have quickly recovered from the March 2007 turbulence on Chinese stock markets and sustain growth trend.

The price development and trading volume indicates continued interest of private investors. Financial analysts also keep buy or hold recommendations on for all three stocks (see Lai 2007, Chu et al. 2007, for example). However, there is some concern that bank stocks, as well other stocks on mainland A-market are driven by a market bubble. The demand for shares is driven by

individual investors in mainland China, who convert their repressed-rate saving accounts into trading accounts and bet their life savings on the bullish stock market (Wehrfritz 2007). However, this does not apply to Hong Kong market where valuations remain more conservative[41].

Exhibit 11: Big Three H-shares: post-IPO share prices (HK$)



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[41] Farrell et al. (2006:47) calculate that on average the A-shares on the mainland are traded at 50 percent premium over the H-share of the same company. They explain the overvaluation by absence of other investment opportunities. Whereas Hong Kong investors may invest worldwide, the mainland investors are confined to China. This may change as China tests a pilot scheme allowing customers of several banks from select regions to make limited investments in Hong Kong. This is expected to boost Hong Kong market and may reduce difference in stock valuations.

Source: Bloomberg.com

The stock market bubble could undermine the quality of banking assets through three channels. First, restructured banks were allowed to reenter investment banking and insurance business. This allows banks to trade in shares on their own account or account of their direct subsidiaries and thus exposes them to market risk. Until mid-1990s major banks in China operated as universal banks, but they were forced to terminate their divisions involved in brokerage (and in international transactions and credit cards) as a reaction to the uncontrolled credit boom associated with illegal speculation and fraud (Girardin 1997)[42]. In recent years these laws were amended and restructured banks are allowed to reenter other segments of financial services market again (Brean 2007).

Second, banks may take stocks as collateral for some loans. Inflated stock prices may encourage the spiral when loans are used to buy more stocks that are than pledged for more loans. Widespread use of such arrangements would not only fuel the stock market bubble but also guarantee pile of bad loans in banks' books should the asset bubble burst abruptly[43].

Third, booming stock market increases incentives for misuse of bank loans by clients. The CBRC increases pressure on banks to monitor loans and identify such situations. Some banks, including ICBC and BOC, were punished for allowing their client – the state-owned enterprise –

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[42] The situation resembled the financial turmoil preceding the Great depression in the US and was resolved by laws inspired by Glass-Steagall Act that separated commercial and investment banking.

[43] Fitch (2006: 6) reports that 9 listed Chinese banks made marked-to-market losses on their securities for sale portfolio amounting to more that USD 1 bn in the first half of 2006 alone.

to invest its short term loans into stock market and real estate. Such speculation increases leveraging of corporations and thus potential fall out of any stock market downturn.

Despite these concerns over banks role participation in the stock market boom, the optimism of stock market players is supported by major credit rating agencies, at least in their short-term outlook. They support the view that the Big Three are reliable partners within the global financial system, but also indicate that the external assistance remains highly probable in case of need.

Exhibit 12: Past and current rating of the Big Four

	Bank deposits				Senior Long-term debt		Financial strength	
	Long-term		Short-term					
Bank	1997	2006	1997	2006	1997	2006	1997	2006
ICBC	Baa2	A2	P3	P1	Baa2	A2	E	E+
BOC	Baa2	A2	P3	P1	Baa2	A2	E+	D-
CCB	Baa2	A2	P3	P1	Baa2	A2	E	D

Source: Davies (2006)

The Bank Deposit Ratings evaluate bank's ability to repay punctually its foreign and domestic currency deposit obligation (Moody's 2007: 22). A decade ago the Big Four banks were rated as offering "adequate credit quality… [with] certain protective elements… unreliable over any great length of time (i.e. Baa)." Today, Moody's considers them a "good credit quality, [although with] elements ... that suggest a susceptibility to impairment over the long term (i.e. A)." In other words, in the short-term the Big Four will be able to pay its obligations, but problems in the longer term are likely. This is consistent with our review of prevailing regulatory and governance problems.

Relatively lower ratings of their Financial Strength indicate that the ability of the Big Three to repay obligations punctually has a lot to do with "implicit and explicit external support elements" provided by the Chinese state[44]. In terms of financial strength the Big Four

[44] The Financial Strength Ratings do not address the probability of timely payment, but measure of the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or

achievements over the last decade are rather reticent. The "E" rating is the worst possible. It displays very modest intrinsic financial strength, with higher likelihood of periodic outside support or an eventual need for outside assistance[45].

Exhibit 13: Current bank rating (Fitch)

Bank	Long-Term IDR	Individual Rating	Support Rating
ICBC	A	D	1
BOC	A-	D	1
CCB	A-	D	1

Source: Chu et al. (2006:1)

The snapshot of Fitch Ratings (2006) also confirms the picture of short-term stability and longer term uncertainty. Fitch explicitly states "that the likelihood of state support for any bank under stress remains very strong…[w]hile full compensation for local depositors is nearly certain, the extent of coverage for other creditors is less clear" (Chu et al. 2006: 1). Fitch Ratings keep the Support ratings at 1, indicating presence of implicit government guarantee behind the Big Three.

The too big to fail logic is an obvious explanation of the implicit government guarantee. If the Big Three are not too big to fail, then this concept has little meaning. They, together with unreformed ABC, hold over 50 percent of all deposits in a society where the savings rate is 50 percent and there are no other investment opportunities for retail savers[46]. Household savings

official institutions. Considered factors include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. They do take into account other risk factors such the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision (Moody's 2007).

[45] Such institutions are typically limited by one or more of the following factors: a weak and limited business franchise; financial fundamentals that are materially deficient in one or more respects; or a highly unpredictable or unstable operating environment (Moody's 2007:25)."

[46] This is changing fast, however. In 2006, retail investors were opening trading accounts at a rate of 300,000 a day (Traders at the Shanghai Stock Exchange, Bloomberg, June 26, 2006) and many savers now bet their life savings on the stock market. Moreover, as in any previous credit boom, there has been an expansion of illegal black market banks that circumvent the regulated deposit rates and offer more. It is estimated that they lend up to USD 100 bn a year; the last uncovered illegal bank operated for more than

are motivated by personal insecurity arising from absence of functioning welfare system. Families rely on their savings to cover any emergencies as well as their housing, pensions, healthcare and education needs. At the same time, there is no explicit deposit insurance; therefore any loss of savings in the Big Four would translate to loss of elementary security for large proportion of Chinese population. Corporate savings in China are also exceptionally high, because retained earnings are major source of investments and there are few financial products corporations could invest their free cash flow in. Therefore any form of banking crisis would threaten livelihoods and jobs on massive scale. That could easily destabilize the communist party rule that derives legitimacy largely from sustained growth and improvement of economic circumstances[47].

Given the high political stakes uncompensated bank failure is unimaginable, unless coinciding with economic meltdown that would have to be on the scale of Asian Crisis or perhaps Great Depression. The Chinese state has capacity and resources to intervene and prevent full-blown banking crisis. Chinese foreign exchange reserves are approaching 1,400 billion dollars, which is equivalent to about 47 percent of total assets of the Big Four in 2006. Moreover, Chinese debt remains low and China has good access to international borrowing, thus resources for further bank bail outs would be available.

That makes the implicit guarantee very credible and open banking crisis very unlikely. Combination of forceful reasons and sufficient resources justifies expectations of private investors that the largest Chinese banks will not be allowed to fail. Essentially, share prices of the Big Three have at least as much to do with economic fundamentals as with political fundamentals that make implicit guarantee credible.

The medium term macroeconomic outlook also suggests that there is no macroeconomic crisis that could undermine the credibility of the implicit guarantee. That is important for market perception given the general consensus on close relationship between the growth rate of the

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8 years, did business in every province of the country and its clients included state-owned enterprises and foreign multinationals ("Black-market banking", The Economist, August 9, 2007).

[47] Especially the urban population that has no or limited access to social welfare net and no land to fall back on in case of need would be hit hard. These protests would be more difficult to contain protests than in rural areas, where violent protests are fairly frequent even now (Tanner 2004).

economy and financial performance of largest banks (CEQ 2006, Chan et al. 2007, Lai 2007, IMF 2006). Long term outlook remains uncertain as ever since onset China's reforms. Many economists point out that there is a limit to her growth model. For example, Csaba (2007) argues growth potential stemming from structural factors and informal institutions will be exacerbated in the long term. This would inevitably slow down economic growth unless there is a shift to more mainstream, more productivity enhancing growth model.

In the short and medium term the most important threat to economic stability continues to be overheating. The rate of savings in excess of 50 percent GDP and less than full sterilization of foreign exchange reserves floods the financial system with liquidity. Liquidity is then turned into credit expansion that drives less and less efficient and more and more speculative investments[48]. In 2006 a package of measures that included increase in bank reserves ratios, increase of interests rates and administrative measures reducing investments into real estate and overcapacity sectors, were introduced. These were only partially successful. Chan et al. (2007:8) report that growth in fixed asset investment in urban areas dropped to 26.6% in late 2006 from 27.2% a year earlier. The growth of commercial real estate construction more then halved in 2006. From nearly 40 percent growth year earlier it has fallen to still high 16 percent. High demand for housing in urban areas is driven by still affordable mortgages,[49] which somewhat reduces the risk of a quick collapse of the real estate prices. Their growth too slowed down from 7.5 percent at the end of 2005 to 6.7 in the third quarter of 2006.

These figures indicate that cooling off measures were only partially successful. Although the growth rates in fixed and real estate assets slowed down, they remain high. Consequently, the annual economic growth still oscillates between 11 and 12 percent, which is high even by the Chinese standards. Although there is no prediction of immediate macroeconomic crisis, the continued investment boom may result in banking losses later on. The soft landing that would reduce this risk is yet to materialize.

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[48] There is some evidence that investments are increasingly inefficient. China need to invest 5 dollars to generate 1 dollar of new output. During their rapid industrialization periods, Japan and South Korea Incremental capital-output ratios were 3.5 and 3.7 respectively (Farrell et al. 2006: 78).

[49] Lai (2007: 9) calculates that proportion of average monthly mortgage payment to average urban household income remains low at 34%, although in Beijing and Shanghai it is over 50%.

Conclusion

We have reviewed the progress of reforms of the three largest banks in China. We aimed at finding out whether they became independent commercial entities operating according to international banking practices. The evaluation was based on the idea advanced by the Financial Stability Forum that the best way to promote financial stability and development in emerging banking sectors is to adopt international best practices in banking governance, risk management and supervision. Our conclusion is that while major banks were stabilized and international standards are being implemented there are three important caveats which undermine reform achievements.

First, it will take a lot more time before the modern banking practices proliferate from headquarters to every local branch. This is not surprising given the short span of the most recent reforms – the implementation of international standards started only in 2003. Enormous size of major banks' operations also slows down the spread of new practices. Current state of reforms thus represents only partial equilibrium that still does not prevent banking practices detrimental to banking stability. These are however more constrained by new regulatory and governance mechanisms than were absent in past. However, time alone will not solve the problem as the next caveat suggests.

Second, international standards are implemented in a selective manner. Those aspects that help to concentrate key powers in the center of banking and supervisory hierarchies are implemented rather vigorously, whereas principles that require independence of banks' boards and regulators are ignored. In the logic of international standards this is a fundamental flaw. It means that incentives of bank directors and bank supervisors are geared towards fulfilling objectives defined by the State Council and the Party, even though these might be in contradiction with the long term stability and profitability of major banks. Without reasonable commercial independence of bank managers and independence of bank supervisors the system can not be expected to follow the logic assumed by international standards.

However, even the selective implementation of international standards represents important improvement. Many technical aspects have been introduced, which makes banking sector more transparent and readable both for national as well as international stakeholders. On the other

hand, the lack of independence of supervisory bodies substantially undermines the credibility of all reported information and invites a lot more uncertainty. The lack of independence is compounded by several technical departures from international practices (such as classification rules that favor lending to projects backed by the central government). This situation leaves more room for manipulation of performance indicators and thus fuel speculation about what the "real" situation is. Such loopholes also allow continuing soft lending practices that resulted in heavy losses during the previous surges in banking credit. In short, the recent reforms have not reached the stage where the repetition of the vicious cycle of soft-lending followed by bail out would be credibly prevented.

Third, the banking reform takes place in the context of transformation of Chinese economy. This brings in many intervening variables such as weaknesses of supporting institutions – from accounting and auditing standards to free financial press, to prevalent corruption and to sizeable proportion of regulated prices. These factors combined make banking operations based on international standards more difficult, even if these standards were fully implemented. Moreover, other characteristics of the Chinese economy such 10 percent growth, 50 percent saving rate and liquidity generated by sterilization operations of the central bank, make it easier to postpone further reforms.

The most interesting finding of this review is the selective use of international standards. That reforms take time and are complicated by other characteristics of economy in transition is well established and does not need further discussion. However, interpretation of the selective use of international standards can be interpreted at least from three viewpoints.

The received view of the Financial Stability Forum is that departure from international standards is detrimental for reform outcomes in emerging economies. International best practices are perceived as minimal, internally consistent set of principles that should create incentive matrix that would facilitate prudent, profitable banking operations and prevent distortions in international competition. Therefore selective implementation of international standards that introduces many technicalities but avoids some of the most important principles should be regarded as reform failure. In the case of Chinese banking reforms the reform failure is a consequence of a fundamental flaw of the reform design, not just a temporary problem. There

are no plans for reforms that would guarantee independence of banking regulators and it is questionable whether such arrangement would be possible without political reforms[50].

From the developmental perspective the selective implementation may be a good news. It creates policy space for the government to support its development strategy by multiple tools including the state owned banks that remain under the firm control of the State Council and the Party. After all, number of East Asian states have used repressed financial sector to support its export oriented developmental strategy (World Bank 1993). The obvious drawback of this strategy is that repressed banks may fuel speculative borrowing that will do little for real sector restructuring. Instead it may contribute to asset value bubble in stock market, real estate and other overheated sectors that will eventually turn many loans into losses as it happened after early 1990s banking boom (Girardin 1997).

The success of the developmental strategy depends on the government ability to keep the right balance between the need to provide favorable financing to project important for development one hand, and need to ensure financial stability of banks on the other. Chinese record in pursuing heterodox economic policies in various sectors is enviable (Qian 2003). However, banking reforms to date can not be regarded as one of these success stories as evidenced by the repeated bail outs. On the other hand, the CBRC may be able to strike better balance between the policy roles of the Big Three and need to ensure that losses would not threaten banks' stability. If that was a case, China might be able "to cross [the banking reform] river by feeling for the stones" as Deng famously recommended.

The third interpretation may be that selective implementation of international standards reflects specifics of the Chinese institutional environment. It is well established insight of the new institutional economics that transplants of foreign institutions, such as international standards in banking, require some tweaking to make them work in the local environment that is short of important supporting institutions. This could certainly explain some departures from best practice in loan classification, risk weighting and other technicalities. However, the absence

[50] Political independence of regulators falls into similar category as independence of courts, which is fundamental for the rule of law. There is extensive debate whether rule of law is possible in a one-party state. See, for example, Wei 2003, Diamond 2003 or Friedman 2003.

of independence goes against the logic of international standards and thus can not be regarded as mere local adjustments.

For now major banks remain part and parcel of Chinese state run transformation. If the experience of smaller transition economies is any guide to the future, then we should expect that China would chose (or be forced by harsher economic circumstances) to converge to the international standards and allow international bankers to take managerial responsibility. Such a scenario would allow it to reap the benefits of FDI in banks as it did in the real sector. Alternatively, China may defy the experience of other transition countries and sustain the developmental model for much longer. That would require designing and implementing such bank governance and regulatory arrangements that would ensure stability of state controlled banks even under less benign economic conditions. That is not straightforward as the international experience shows that state run banks tend to require repetitive state-run bailouts, especially if they are as important as in China. It remains a question for further research to see which way Chinese reforms would move from the current stage.

Nevertheless, the evidence gathered in this paper is sufficient to dispel some of the excessively optimistic interpretations of recent Chinese reforms. Namely, it suggests that Chinese banks are not yet like any other large commercial banks on the global markets and that the regulatory framework in China still suffers from major loopholes that create room for distortion in reporting and disclosure of key stability indicators. The view that listed Chinese banks, for now restructured and cleared of legacy NPLs, operate like any other large banks is driven by a cursory look at financial indicators. However, at closer look there are serious doubts about sustainability of the favorable financial indicators. On the performance level, we have pointed out fast credit expansion and high proportion of substandard loans as two major threats. On the bank governance level, the limited role of strategic investors, market oversight weakened by implicit state guarantee and lack of commercial independence of bank governance bodies, suggest that major banks are not commercially oriented entities. In short, the Big Three banks retain “Chinese specifics” in their daily operations that ought to be considered when assessing their future prospects.

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