

Challenges for China's banking sector and policy responses¹

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It is indeed a privilege and honor for me to participate in this important seminar and speak before such a distinguished audience. The topic for discussion at this session is the reform strategies in the domestic financial sector. As a banking supervisor, I think that the best way for me to contribute to the discussion is to focus my presentation on China's banking sector, which is by far the most important segment of the financial sector. I will first briefly describe the banking market, identify the challenges facing the banking industry and then highlight the recent policy responses, particularly those introduced by the newly established banking supervisory authorities.

¹ The views expressed in this paper are the author's views and do not represent the views of the China Banking Regulatory Commission.

I. Banking market in China

At the present, banks continue to dominate China's financial landscape as such indirect financing remains the main channel of financing for business companies in China. By the end of 2002, the total assets of the banking sector are 26.4 trillion yuan², representing 85 percent of the total assets of the entire financial sector. Although the role of capital markets has become more significant, the size of these markets remains quite small, with a capitalization of 1350 billion yuan by end June 2003.

China's banking sector comprises many institutions. These include state-owned banks, joint-stock banks, city commercial banks, and credit cooperatives etc. However, the banking market is dominated by the four state-owned commercial banks, which account for 61 percent of the loans. Some academics argue that this is typical of an oligarchic market, which tends to lower the efficiency for allocating financial resources and result in distortions in the system. Further, dominant ownership in the banking sector tends to erode the credibility of the threat of market failure and the effectiveness of the banking supervisory authorities to enforce prudential rules and requirements.

The second tier of the banking market comprises eleven joint-stock commercial banks with a diversified ownership structure. However, the key shareholders of these banks are local governments and the state-owned or state-controlled enterprises. In September 2003, their assets represent 13.7 percent of the total banking sector assets. These banks have expanded rapidly in recent years. For example, in 2001 alone, their assets increased by 24 percent. At present, five joint-stock banks are already listed in local stock exchanges.

In September this year, there are 112 city commercial banks, most of which are created by way of restructuring and consolidating urban cooperatives. These banks represent 5 percent of the total banking assets. In addition, there are 35,588 urban and rural cooperatives, accounting for 10 percent of the total banking assets.

² The current exchange rate is one US dollar to 8.27 Chinese yuan.

Foreign banks play a positive but at least for now rather limited role in the system. In September 2003, there are 191 licensed foreign banking institutions in China, among which 157 are foreign bank branches, 11 sub-branches, and 15 subsidiaries incorporated locally with 8 branches. Foreign banks represent 0.3 percent in the local currency lending market and around 13 percent in the foreign currency lending market.

II. Challenges facing the banking industry

Despite the improvement of the asset quality in recent years, the size of non-performing loans (NPLs) is generally considered the major threat for the banking system in China. In September this year, the NPL of the banking sector, including state owned banks, policy banks and joint stock banks, amounted to 2,532 billion yuan measured according to the five-category supervisory loan classification system, and the NPL ratio is 18.7 percent. The non-performing loans of state-owned commercial banks reached 1,999 billion yuan and the NPL ratio is 21.4percent, an equivalent of 20 percent of GDP of 2002.

The asset quality of the joint-stock banks varies. Some have healthier balance sheets than the state owned banks. The NPLs for joint-stock commercial banks is 8.5 percent on average. The asset quality of other banking institutions is just as worrisome. Most of them are still using the four-category loan classification system based on the status of past-dues. This old classification system is less stringent. Although the figure for NPLs for these banks is not comparable with that for the state-owned banks and shareholding banks, it is generally believed to be higher.

However, data weaknesses and judgment bias adopting the supervisory loan classification also suggest that the scale of problem loans may be higher. These weaknesses include the relatively large share of loans classified as special mention and doubtful, the lack of proper treatment of restructured loans and foreclosed assets, and not to mention, losses from non-credit activities.

At present, the capital adequacy ratio for most Chinese banks is below regulatory requirements. At the end of September this year, the composite capital adequacy ratio of the state-owned commercial banks is merely 4.61 percent, significantly below the minimum regulatory requirement of 8 percent. The same ratio for joint-stock commercial banks and city commercial banks are 6.83 percent and 6.01 percent respectively. Further, as the existing capital rules have favorable risk weights for loans secured by physical collateral and guaranteed by other third parties in addition to banks, the resulting capital charge for credit risk is less than what would be the case following the 1988 Basel Accord. Most importantly of all, capital adequacy should be calculated on the assumption of sufficient provisioning for loan losses. Therefore, having allowed for the deficiency of provisions for loan losses, the capital adequacy ratio for Chinese banks will fall sharply and becomes much smaller in all banks. From a supervisory perspective, a de facto low capital adequacy ratio is much better than one that appears to be high but less meaningful.

By way of example, the five publicly listed joint-shareholding banks are better provided among Chinese banks. Yet, for one listed bank, the loan loss coverage ratio is 36.9 percent³. It is true that the asset quality of these banks is better than that of the state-owned, but further improvement in provisioning is also needed.

Besides low capital base and asset quality, banks in China also suffer from poor corporate governance, and internal controls and a lack of adequate risk management skills. Particularly, the state-owned banks suffer from all corporate governance weakness as non-financial state-owned enterprises. The present structure of state ownership accounts for at least some of their less satisfactory performance. No wonder that in the on-going reform program for the state-owned banks, the government is so determined to press ahead with the corporatisation and ownership diversification with these banks. Yet, the state or public ownership will continue to dominate, even although it may take a variety of forms in practice.

Banks in general are aware of their financial difficulties. For years, most banks choose to resolve their problems through fast expansion. Banks depend on the revenue from

³ See the annual reports of the five listed shareholding companies. The loan loss coverage ratio is defined as the total amount of provisions divided by the total amount of NPLs.

such an expansion to charge off bad loans and strengthen their capital base and at the same increase their market share. Commonly heard justification underlying this approach is the quote of China's reform strategy, i.e., the development/growth is the hard truth. By way of example again, from 1998 to 2002, bank loans increased by 11.6 to 15.5 percent per annum in the past five years, while the GDP growth rate is between 7.1 to 8 percent. Given the magnitude of banks' financial problems, supervisors also find it difficult to enforce supervisory actions on banks for non-compliance with prudential rules requirements.

Indeed, the trend of fast expansion is particularly prominent in the first half of this year. By end September of 2003, the total loans outstanding reached 16.7 trillion yuan, representing an increase of 2.7 trillion yuan in first three quarters this year, exceeding the total lending increase of the previous year. Generally, the sufficient liquidity attributed to the high savings rate and the lack of other investment alternatives fuels the banks' dramatic lending increase.

III. Some other factors affecting banks' sound performance

Tax policies

The failure to resolve the bank problems would put China's financial system at risk and adversely impact on sustainable growth of the economy. Over the years, a number of actions have been introduced to improve the healthy development of the banking industry. For example, the fiscal authorities rejected 270 billion yuan of capital into the state-owned banks, off-loaded 1.4 trillion bad loans from the state-owned banks, reduced time required to recognize interest receivables to 90 days, and lowered the business tax to 5 percent from 8 percent. However, the tax policies on banks are particularly unfavorable and continue to affect their prudent operations and profitability.

At the present, commercial banks are subject to two main forms of taxation:

- Business tax, based on revenue, is currently 5 percent.
- Income tax, based on profit, is set at 33 percent for domestic commercial banks

The level of corporate income tax levied on commercial banks is high and it makes it difficult for commercial bank to operate on a sound and commercial basis. Further, it compares unfavorably with the tax rate for foreign banks. In terms of foreign currency operations, foreign banks are subject to a tax rate of 15 percent, with a full tax holiday for the first year of operation and a 50 percent tax holiday for the second year (15 percent is applied from the third year onwards).

While the corporate income tax level may not be a cause for concern, business tax and tax-deductible specific loan-loss provisions are particularly penalizing for banks.

The high level of revenue tax erodes profitability. China is one the very few countries in the world that impose a business tax on gross income for banks. Until 2001, the business tax rate was 8 percent (3 percent collected by the central government, 5 percent by the local government). Since then this rate has been reduced by 1 percent a year until January 2003, and to date it is 5 percent. Such revenue tax makes it difficult for banks to generate and retain earnings and thus to strengthen their capital bases. By way of example, ironically back in 1998 when the business tax was at 8 percent, four state-owned banks alone paid 11.6 billion in business tax and generated a total profit of only 4.1 billion.

Further, a significant tax-based disincentive still needs to be removed in order to encourage banks to increase their provisioning levels. Following the supervisory rules, banks are now required to make provisions based on the five-category loan classification system. However, At present, the tax authorities impose a cap on the tax deductibility of specific loan-loss provisions at 1 percent. This severely discourages commercial banks to make adequate provisions that are urgently needed to accelerate loan write-offs and comply with supervisory rules.

In short, banks in China have to pay higher taxes than their operations and profits could support, resulting in de-capitalization. The tax treatment of provisions leads to overstatement of profits, which are then subject to taxes. Only when specific provisions are tax deductible, will financial institutions be more willing to classify

loans according to their true prospects for collection, rather than making recourse to sequential rescheduling to avoid regulatory norms on provisioning.

Unfavorable treatment of banks claims in case of bankruptcy

The resolution of the problems in the banking sector depends critically on the reform of the state-owned enterprises (SOEs). These enterprises represent the vast majority of the state-owned commercial banks' loan book and recurring non-performing loans. In this context, the structural problems of these banks cannot be successfully addressed unless the SOEs are at least partially rehabilitated and have become credit-worthy borrowers.

In the reform practice, the SOEs restructuring started much earlier. In the interest of social stability, banks largely bear up the reform cost of the SOEs. For example, by the end of 2000, 51.2 percent of the 62,000 firms that had completed their change of ownership failed to repay bank loans⁴. In fact, there has been so much stress on the appropriate terms of settlement for employees of the bankrupt enterprises that some restructuring of SOEs proceeds at the expense of banks when enterprises are closed down or declare bankrupt.

IV. Policy responses to resolve banking problems

Policy-makers in China have always faced the enormous challenge of balancing the need for rehabilitating the banking sector and restructuring the SOEs. As the reform of state-owned enterprises is the key to the overall success of economic restructuring, the reform of the real sector has been progressing persistently.

In this year's annual report, following years of unremitting efforts, the government considered that the objective of turning state-owned enterprises around within three years had been reached in general. Most large and medium-sized state-owned enterprises had achieved the goal of establishing a modern corporate system. Specifically, over the past five years, 442 important state-owned enterprises were

⁴ See a report of the People's Bank of China in 2002

listed in the stock exchange⁵. A variety of measures, including debt equity swaps, were adopted to reduce their historical burdens and a large number of insolvent state-owned enterprises were closed down. Going forward, the government plans to empower the state asset management agency to manage the state assets in the capacity of shareholder, and press ahead with the reform of some monopolistic sectors, such as telecommunication, power supply and airline industry.

Having achieved significant progress in the real sector, the government has come to address the difficulties in the banking industry, which is another demonstration of the sequenced approach to reform. Last month, in a document outlining the overall economic reform strategy, the government reaffirms the need to intensify the financial sector reform. It makes it clear that all financial institutions, be they commercial banks, securities companies, insurance companies or trust and investment companies, should be turned into modern financial business entities that have adequate capital, strong internal controls and operate profitably in a safe and sound manner. Selected state-owned banks shall be restructured to become shareholding banks. Efforts will be made to expedite the resolution of state-owned banks' problem assets and inject capital so as to create the necessary conditions for public listing in the future. Medium-sized and small financial institutions should be restructured, while leveraging financial resources from outside.

Obviously, the reform of the financial sector is going to be a long and challenging process. Unquestionably, in restructuring the banking industry, the reform of the state-owned banks is a high priority. This would require rejection of additional capital and resolution of problem assets. Also, a change of corporate governance is needed, which includes among others, putting in place a set of well-defined responsibilities for the shareholders, board of directors, board of supervisors, a diversified ownership structure, preferably with the participation of foreign strategic investors, a clear mandate to maximize profits, and an overhaul of the existing organizational structure. At this stage, the specific measures for implementation of the above strategy are in the making.

⁵ By the end of 2002, more than 80 percent of all small and medium-sized enterprises have been transformed with a significant portion sold to employees and outside investors. About 12,000 large companies have diversified their ownership through public listing.

It is encouraging to note that the Ministry of Finance is highly pro-active on these issues. Last month, a senior finance official confirmed that the Ministry of Finance stands ready to support the banking sector reform and has the capacity to do so without jeopardizing the budgetary sustainability. According to his estimates, the deficit is at 3 percent of the GDP in line with the comparable international benchmark. The explicit debt ratio, i.e., the outstanding liabilities over the GDP, is around 18 percent, while the implicit debt ratio is 40 percent of the GDP, which adds up to slightly above 50 percent, still below the 60 percent average internationally. The fiscal authority intends to maximize the use of public fund at the minimum cost.

With respect to a roadmap for reforming the state-owned banks, the senior finance official suggests that the four state-owned banks should, first of all, improve corporate governance and internal controls. As the next step, they should diversify the ownership structure to become joint-shareholding companies. Finally, they should go public when some conditions are met. Indeed, the central bank government also noted recently that without government's financial support, it would take much long for the state-owned banks to clean up their balance sheet.

We, the banking supervisors, have the responsibility to facilitate the changes in all areas relating to the banking sector reform, even although they may fall within our competence. We also believe that there is a need to introduce comprehensive and well-defined accounting rules, bankruptcy laws, efficient resolution procedures for problem banks, and preferably a deposit insurance system.

Indeed, the creation of the China Banking Regulation Commission (CBRC) in April this year again demonstrates the government's determination to reshape the banking sector. As many of you may know already, China used to adopt a mono banking system similar to other centrally planned economies. Since its creation 1984, the central bank had a broad mandate to regulate and supervise the entire financial sector. In 1992 and 1998, a separate securities regulator and then an insurance regulator were set up respectively. At a result, each segment of the financial sector, namely, banking, securities and insurance, is regulated and supervised by a separate government agency along the business line.

We supervisors at the CBRC feel confident that the new regulatory framework will help deliver stability and strengthen banking supervision. We share the view that the regulatory structure for banking is rather individualistic and should reflect a country's economic and political environment. As the detailed programs for restructuring the banking sector and putting in a sound supervisory framework continues to be evolving. It may be helpful to give a perspective to a number actions introduced by the newly established banking supervisor. However, what is important is not to review what the CBRC has achieved so far within such a short period of time, but to assess what the CBRC's strategy is for the future and how it plans to achieve it.

There has been a high expectation on the CBRC at the time it started its operations. The industry expects the CBRC to be independent, and accountable and at the same time demonstrate a high level of professionalism. Indeed, we, at the CBRC, have been fully aware of the potential pitfalls and we must ensure that the creation of the CBRC is not a mere split from the central bank and that the CBRC will develop the right mission, and introduce new supervisory concepts and methodologies in building a strong banking sector and supervisory system.

In an effort to accomplish this, the CBRC first reviewed the supervisory experiences of the past. The CBRC top management wanted to make sure even if the supervisor cannot completely avoid making new errors, it must avoid repeating the mistakes of the past. Following this review exercise, four major lessons were identified. These include: the supervisor should focus on the supervision of legal entities on a consolidated basis; the supervisor should stress risk management by banks in addition to a review of compliance; the supervisor should urge banks to put in place a system of internal controls; and the supervisor should promote transparency of both the supervised institution and supervisory agency. It is not exaggerations to say these lessons are learnt hard way, and behind them are years of experiments and frustration to achieve clear progress.

Based on this review, for the first time the CBRC top management clearly set out four objectives for banking regulation, which include the protection of consumer and maintenance of stability in the banking system etc. The top management also

formulated a set of principles to assess the result of our supervisory activities. These include among others, maintaining systemic stability, enhancing banks competitiveness and encouraging competition.

This exercise has proved to be extremely useful in defining the mission for the institution. It also provides critical input to the draft law for the CBRC, which is now under consideration by the Congress and is likely to be adopted by the end of this year. The draft law draws extensively from the Basel Core Principles for Effective Banking Supervision as well as the emerging best practice for supervision such as legal protection of supervisors, accountability and transparency. Indeed, this important legislation will provide the legal basis underpinning all the regulatory and supervisory activities of the CBRC and shape the direction of banking supervision for many years to come.

All the recent regulatory and supervisory initiatives of the CBRC are intended to give a full and practical expression to the CBRC's mission or objectives of banking supervision as described above and strive to introduce new concepts and approaches to effective banking supervision. A brief discussion of some specific policy measures brought about by the CBRC during past months may be helpful.

To enforce and improve supervisory rules

While continuing to stress the reduction of NPLs by 3 percentage points each year and the outstanding volume of NPLS, the CBRC took no hesitation to ask all the state-owned banks and shareholding banks to roll out the risk-based five-category loan classification system for supervisory reporting, and completely phase out next year the outdated classification system based on the status of past-dues, whereby default loans could still be classified as performing even when a borrower has ceased operations due to financial difficulties.

By way of ensuring the full and effective adoption of the new classification system both for supervisory reporting as well as improvement of credit risk management by banks, the CBRC recently sent out examination teams to the big state owned banks to examine their implementation of the five-category loan classification system. The emphasis of the examinations was more on the adequacy of banks' procedures and

processes for the classification system rather than the traditional type of transaction testing and verification. This would also help trigger a change of mind-set of banks' senior management for better identifying, measuring and controlling credit risk.

In the meantime, the CBRC is also in the process of improving the coverage of the existing classification rules to address off-balance sheet items, non-credit assets, restructured loans and foreclosed assets as well. In light of the relevant provisioning rules for classified loans, the CBRC stresses that banks should pursue timely recognition of loan impairment and build their provisions or reserves accordingly. Under-provisioning is the single largest distortion in the calculation of capital adequacy. There should be no tolerance or forbearance for less prudent provisioning policy or practice.

To promote competition and leverage off the role of foreign banks

No evidence so far suggests that foreign banks in China could destabilize the local banking market. The CBRC shares the view that the most important question is not who provides banking services but who can provide them more efficiently. Indeed, since the late 80's, the role of foreign banks has become increasingly important for China's banking sector. They have brought in competition and helped unfold many changes in the banking sector. As the country continues to honor the WTO commitments and eventually remove all the geographical and customer restrictions on foreign banks, the policy towards foreign banks has become more and more supportive.

The CBRC is now assisting foreign banks to become niche players in consumer lending, wealth management, asset securitization and resolution of problem loans. It also encourages foreign banks to have equity stake or become strategic investors in Chinese banks, big or small. The existing ceiling for the foreign holding in Chinese banks is being reviewed. This helps to reach a win-win situation for both local and foreign banks and facilitates a quicker expansion of foreign banks' operations nationwide.

To improve banks' risk management

The CBRC underscores the fact that banks are run by banks' management and not by the supervisor. However, the supervisor has the duty to promote best practices for risk management and encourage the improvement of banks' risk management. The CBRC has aggressively introduced the new supervisory concepts and approaches as embodied in the New Capital Accord, or Basel II for short.

The draft capital rules state, in line the three-pillar approach off Basel II, that banks should improve their risk management beyond the narrow compliance with a minimum capital requirement. In light of the nature and size of their operations domestically and overseas, large banks should build a robust internal credit risk rating system benchmarked to Basel II and small banks should introduce, the best they can, elements of best practices for managing credit risk. All banks should start collecting the necessary data for both borrower and facility, which serve the very basis for a more quantitative approach to measuring and managing credit risk. Over time the CBRC will consider the use of an internal ratings-based approach for capital regulation when banks are ready and provide incentives for banks to improve their sophistication in risk management accordingly.

It is encouraging to observe that at the support of the supervisor, big banks in China have fully embraced Basel II in the interest of better risk management. Some have already designed the two dimensional rating systems with more refined risk distinction for performing loans and benchmarked to probability of default. Some are ambitious enough to aim at the advanced IRB (internal-ratings based approach) following the successful launch of the foundation IRB in three or four years' time.

Benchmark to international standards

Most importantly, the CBRC is keen to improve banking supervision in line with international standards. The Chinese supervisor was involved in the drafting of the Core Principles for Effective Banking Supervision and has for long served as a member of the Core Principles Liaison Group. Recently, the CBRC initiated another more rigorous and objective self-assessment of the Core Principles both against the

essential and additional criteria. This exercise is intended to identify gaps and weaknesses in the existing system for banking regulation and supervision and draw up an action plan for improvement.

The assessment report will be reviewed at the first meeting of the Council of International Advisors, which will take place next week. The Council members include prominent supervisors such as Andrew Crockett, the former general manager of the Bank for International Settlements. The Council members will advise the CBRC of various strategic issues relating to China's banking supervisory regime and offer policy recommendations how to build an effective system of banking supervision in China in line with international standards and best practice.

Coordination with securities and insurance supervisors

In addressing the cross-sector supervisory issues, the CBRC took the initiative to set up a regular mechanism for cooperation among the securities and insurance supervisors. At the first meeting in September, heads of the three supervisory authorities recognized an urgent need to work together on various cross-sector issues. They defined a clear framework to address cross-sector issues whereby supervision of banking, securities and insurance firms within a financial holding companies will be undertaken by the supervisor in the respective industry, and supervision of financial holding companies will be undertaken the relevant supervisor in light of the companies' major business line.

V. Conclusion

In contrast to the shock therapy, China has long adopted a gradualist approach to its far-reaching economic reform program. By definition, this approach implies that incremental changes are made when needed, and the easiest part of the reform process is usually tackled first and the toughest aspects are postponed till later. The experience of this reform is learnt by trial and error where Pareto improvement if not optimality is commonly recognized. In the whole reform process, the government has endeavored to strike a proper balance between the rehabilitation of the banking system and the imperative to maintain stability and sustain the economic reform.

Perhaps, banking reform is one of the last and most fundamental aspects in China's macroeconomic reform. Having achieved significant progress in restructuring the real sector, the government has moved decisively to address the difficulties in the banking sector. The creation of a new banking supervisory agency is a testimony to the government's renewed commitment to achieve major breakthroughs in the banking sector reform.

The overall direction of the banking reform has been clearly identified, while the formulation of specific policy measures is already in progress, which may well include an overall of corporate governance and the potential use of public fund to re-capitalize the state-owned banks, of course under certain conditions yet to be specified. The newly created banking supervisor is well positioned to take the challenges in reforming the banking system. The CBRC's agenda is ambitious and but similar to the reform in the real sector, banking reform could be more challenging than expected. However, the recent initiatives introduced by the CBRC suggests that a solid step has been made in another long march toward building a strong banking sector and an effective banking supervisory system in China.