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An Overview of the Chinese Banking System: Its History, Challenges and Risks

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Abstract: This paper is an initial review of the history, evolution and current status of the Chinese Banking Industry. Early conclusions are that the industry segment has been rapidly restructuring and changing since 1979 when Deng Xiaoping implemented major market reforms and that these changes have accelerated with the Country's entrance into World Trade Organization (WTO) in 2001. Evolving from a single government-controlled institution that acted both as a central and commercial bank, to multiple organizations dominated by market fundamentals and increasing competition, these changes have created several challenges for Chinese financial institutions. The preliminary conclusion is that the role Chinese banks will play in future economic development will be dictated by how well the banks are able to adapt to the new market risk and competition created by market reforms.

Key words: Chinese banking system; history; evolution; challenges; risks
JEL codes: N, O

1. Economic Reform and Conditions in China

Before China's economic reforms three decade ago, the Country was characterized as poor, stagnant, centrally controlled, economically inefficient, and isolated from the rest of the world. Since market reforms were implemented by Deng Xiaoping, in 1979 and its entrance into WTO in 2001, China has become one of the world's fastest-growing economies, with GDP growth averaging around 10% a year over the past three decades (Yan, 2014). In addition it is one of the world's largest merchandise trading economies, second-largest destination of foreign direct investment (FDI), largest manufacturer, and largest holder of foreign exchange reserves (Morrison, 2014).

Although still growing at a pace many envy, China's economy has slowed down in recent years because of the global economic crisis that began in 2008. This has included a decline in exports and imports and the loss of jobs for a significant number of Chinese workers. Because of the slowdown, the Chinese government has introduced a stimulus package hoping to control the economic decline. This has included an injection of four trillion yuan ($586 billion) into the economy — equivalent to about 16% of China's annual GDP (The Economist, 2008), easing monetary policies to increase bank lending, and various efforts to boost domestic consumption. While these actions are believed to have helped stabilize the economy, the International Monetary Fund is projecting the Chinese GDP

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will continue to decline through 2015 (WEO, 2014).

While economic growth is slowing, the GDP growth is still the envy of most developed economies and many predict that China will become the world's largest economy in the near future. However, the ability of the country to maintain its growth trajectory for the long run will depend largely on the Chinese government's ability to continue its comprehensive economic reforms and transition to a free market economy. This will include continuing to promote in-country consumer demand for products, encouraging innovation and addressing the significant environmental issues that plague the country. To that end in November 2013, the Communist Party of China held the Third Plenum of its 18th Party Congress, which issued a communique outlining a number of broad policy statements on reforms that would be implemented by 2020. Many of the proposals are measures that would seek to boost competition and economic efficiency (Morrison, 2014). This includes continuing the substantial reforms in the financial and banking sectors.

2. The Evolution of Chinese Banking

China's banking system has changed dramatically since 1970s when there was only a single government-controlled banking institution — the Peoples' Bank of China (PBOC). Since that time and with major market reforms, banking is now beginning to be driven by market fundamentals and some foreign competition has begun to take market share.

The Modern Chinese Banking system started its evolution in 1979 with the spin-off of three banks from PBOC (Yan, 2009). This included The Agricultural Bank of China (ABC) which assumed rural banking activities from the PBOC; the Bank of China (BOC) which focuses on foreign currency transactions and international banking business; the People's Construction Bank of China (PCBC) which is mandate to finance construction and infrastructure projects (Werner & Chung, 2010).

In 1983, the State Council, the chief administrative authority in China, officially designated the PBOC as China's central bank (Turner, Tan & Sadeghian, 2012). The Council also established the PBOC as the main regulator and supervisor of China's early-stage banking system (Werner & Chung, 2010). In order to strengthen its role as the country's central bank, on January, 1, 1984, PBOC transferred its remaining commercial banking functions into a new bank (called the Industrial & Commercial Bank of China (ICBC)), whose mandate was to specialize in urban commercial financing. The Chinese Government also permitted the establishment of a number of other domestic banking institutions from the late 1980s, including the Bank of Communications (BCOM) (Werner & Chung, 2010).

An additional part of the evolution has been to separate policy-related lending from commercial banking in China. This has included the establishment of three policy banks in the mid-1990s — China Development Bank, Import and Export Bank of China, and Agricultural Development Bank of China (Yan, 2009). In addition a law was enacted establishing the four specialized banks (ABC, BOC, CCB and ICBC) as state-owned commercial banks responsible for managing their own operations and risks, in accordance with regulatory compliance guidelines. In addition the Chinese government allowed several joint-stock commercial banks and rural and urban credit cooperatives to be established (Werner & Chung, 2010).

Even with these changes the Chinese government continues to play a major role in the banking business. Along with facilitating and designing regulation for the industry, through the late 1980's and 1990's they influenced and directed lending to many state owned enterprises that were not profitable and relied on borrowed money to fund operations (Lardy, 1999). Along with significant lending into a real estate and stock market boom and the subsequent bust, non-performing loans increased significantly. By the late 1990s the large state-owned banks' aggregate non-performing loan (NPL) ratio exceeded 30 percent (Huang, 2006).

As the banking reforms began to take hold and lending dried up many state-owned enterprises (SOEs) shut down. Since the state-owned commercial banks were the main providers of credit to the SOEs, they were left with serious credit quality issues and non-performing loans grew quickly. Responding to this banking crisis, the Ministry of Finance in 1998 restructured the four state-owned commercial banks and made direct capital contributions of RMB 270 billion or US$ 33 billion. Four asset management companies (AMCs) were then established in 1999 to purchase, resolve and sell the each bank's non-performing loans (Turner, Tan & Sadeghian, 2012). It should be noted that the repurchase agreement only included loans originated prior to 1996. The government deemed loans made after that date were made of the banks on volition vs. directed by government policy (Peiser & Wang, 2002; Pei & Shirai, 2004). This restructuring has seemed to work with both credit quality and capital adequacy gradually improving.

Despite the recent restructuring process during 1998-1999, the banks were still burdened by a substantial level of NPLs which forced a second round of restructurings. These restructurings included both equity infusions as well as NPL carve-outs, resulting in government outlays of hundreds of billions of RMB (Werner & Chung, 2010).

With this restructuring done and the banks successfully recapitalized the Chinese government encouraged State-Owned Commercial Banks to investigate initial public offerings (IPO's) (Werner & Chung, 2010). This was seen as a critical step in the reform process by the government who believed that as publicly traded companies these organizations would be more responsible to non-government shareholders in the form of improved risk and credit management (even though the majority shareholder for the State-Owned Commercial Banks was still the Chinese government). In addition and with a tip of the hat to western banking practices, a number of successful global banks (e.g., Goldman Sachs, American Express, Royal Bank of Scotland, Bank of America) were given unique opportunities to invest in these public offerings prior to public issuance of the stock — a very lucrative transaction. The Chinese government did this in exchange for the investing banks providing assistance and guidance to their new Chinese partner banks on modernize the internal infrastructure of the organizations (Werner & Chung, 2010).

Another important change in the Chinese banking market has been the introduction of foreign competition. Over the past two decades, the gradual and cautious opening of the Chinese banking market to foreign banks has involved stages. First stage — because of significant regulatory limitations on operations, foreign banks initially entered the Chinese market from the late 1970s until the early 1990s as service groups for home grown customers. With the gradual relaxation of rules and restriction on foreign national banks, to a large extent driven by China's accession to the WTO, foreign banks have increasingly been entering the Chinese market believing that servicing local businesses and customers could generate significant profits.

The ultimate impact of foreign bank operations on Chinese banks is not yet clear. The Chinese bankers believe that there could be a loss of market share, reduction in profits as competition increases, or talent drain as banks from other countries began to pirate employees. However many argue that as foreign banks gain traction this will force Chinese banks to improve their service quality, efficiency and general competitiveness. Ultimately, this should enhance the likelihood of the long, stable and healthy development of China's banking sector and financial markets (Yan, 2009).

3. Challenges, Difficulties and Risk in Chinese Banks

With the economy slowing, the prospects of a future increase in NPL's and the market slowly being opened to global competition, it is difficult to imagine that more challenging times are not ahead for the Chinese Banking system. Specifically there are two areas of concern and consideration and possibly further investigation.

(1) The biggest risk for Chinese banks is an increase in non-performing loans and the subsequent economic consequences a bank crisis would have on an already slowing Chinese economy.

Having bailed out the banks twice because of poor lending decisions there is little appetite for another capital injection and there are signs that this might be needed again. The government has spent more than $650 billion bailing out banks since the late 1990s. (Bloomberg News: China Banks' Bad Loans Reach Highest since Financial Crisis) and it is reported that for the ninth straight quarter NPL's are at the highest level since the 2008 financial crisis. This is no doubt a reflection of the slowdown in the world's second-largest economy and a bad omen for the Chinese economy at large and the banking system.

(2) As the financial services markets expand with the arrival of new competitors and alternative deposit and lending options, customers are becoming harder to keep.

In short Chinese banks are finding it difficult to compete in a market where not only foreign competitors are increasingly challenging their turf, but also with new technologies are beginning to encroach on their traditionally stable funding base (Wildau, 2014, financial times Chinese banks shun depositors as rules bite October 1, 2014).

For example two Chinese internet giants, Alibaba and Tencent, are moving energetically into financial services. The online financial products and services offered by these two companies have become an immediate hit and are especially popular among the younger Chinese. Moreover, these innovators already have volumes of proprietary data on the online purchasing habits and creditworthiness of consumers giving them a leg-up on the traditional bankers. For example, "Yuebao", which literally means "leftover treasure" in Chinese, is operated by China's biggest e-commerce firm Alibaba Group. It is a new financial service that made its debut in China last year, which has succeeded in collecting in excess of RMB 8 trillion ($1.29 trillion) from 86 million customers as of mid-March and has become a threat to major state-owned commercial banks like the industrial and Commercial Banks of China. The deposits to this company are said to be still growing at more than 5 percent per month.

One Chinese financial expert has said that with the public support for higher returns and the convenience offered through the internet, more than 30 percent of the money deposited by individuals in major banks could be shifted to online money funds within three years. This could give rise to a scenario in which online financing will occupy a major position in China's financial system (July 1, 2014, The Japan Times, China's shadow bankings' challenge).

The banking system in China although still controlled by the Chinese government has historically played an important role in the development of China's economy. However, with bad loans and new competition it is increasingly difficult to determine how affective they will be in promoting development and supporting the investment needed to grow such a large economy. How these institutions adapt to the changing environment will be a good indicator on the effectiveness of Chinese reform efforts and a leading indicator on the prospects for China's economy.

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