Asia Focus

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China's Banking Sector

*Each year, the President of the San Francisco Fed travels to Asia on a "fact-finding" trip to the region. These trips advance the Bank's broad objectives of serving as a repository of expertise on economic, banking, and financial issues relating to the Pacific Basin and of building ties with policymakers and economic officials there. The knowledge gained and the contacts developed are critical in understanding trends affecting the Twelfth District, in carrying out responsibilities in banking supervision, and in ensuring that policymakers have the understanding of global economic developments necessary to conduct policy and promote the stability of financial markets. This Asia Focus summarizes President Yellen's report to the Head Office Board of Directors on the banking sector in China following her trip to China in November 2006.**

Banking reforms progressing, challenges remain

The Chinese government continues to focus on its bank reform efforts. Reported non-performing loan (NPL) ratios are at historically low levels and equity capital has increased. Four of the five largest banks in China have been financially restructured, recapitalized and listed on the Hong Kong Stock Exchange. Sale of strategic stakes in those four banks to private investors and the banks' IPOs have laid a foundation for improvement in their corporate governance and operations.

Nonetheless, some Chinese banks and their foreign shareholders face numerous challenges. It will take time to build a commercial spirit and credit culture at banks long accustomed to taking direction from politicians and bureaucrats on lending decisions, and the credit approval process remains decentralized. A critical challenge for some banks is the development and retention of talent, particularly in the middle management ranks.

Although Chinese commercial banks are flush with liquidity, most continue to lend primarily to state-owned enterprises (SOEs). Generally, promising and profitable small- and medium-sized private enterprises (SMEs) still find it difficult to borrow from Chinese banks, and political pressures remain for loan officers and branch managers to lend to SOEs.

High volumes of new loan originations have raised concerns about a potential rise in NPLs. In 2005, banks issued RMB 2.4 trillion of new loans. In 2006, the amount rose 33 percent to RMB 3.2 trillion. If prudential standards were lowered in issuing the large amount of new loans, a high percentage of the loans could become non-performing. Officially reported NPL ratios for the major commercial banks have declined in the last four years, from 24 to 8 percent of total loans, and the absolute value of NPLs has roughly halved from RMB 2.3 trillion to RMB 1.2 trillion. However, these NPL figures do not include the full range of problem assets including special mention loans.

At the same time, capital levels at the major commercial banks have improved. Tier 1 capital ratios for four of the five largest banks exceed ten percent, boosted by the injection of capital through IPOs conducted in 2005 and 2006. The tier 1 capital ratios for other commercial banks are lower, around six percent. Given the uncertainty around actual NPL levels discussed above, observers disagree over the optimal amount of loan loss provisions Chinese banks will need, but stock market listings might set a virtuous cycle in motion. The enhanced scrutiny of public listings could prompt banks to provision more against expected future losses, requiring them to seek more capital from markets and subjecting them to further market discipline.

Banking supervision continues to improve

Since its establishment in 2003, the China Banking Regulatory Commission (CBRC) is credited with improving the quality of bank supervision in China. The CBRC has tightened loan-loss provisioning standards, and applied more rigorous asset classification standards to all lending institutions. It has additionally introduced guidelines on market risk management and internet banking.

The CBRC supervisory role includes monitoring established capital and NPL goals for 2007. All commercial banks are required to have risk-weighted capital levels of eight percent in line with BIS standards, as well as to reduce their NPL levels to five percent by year-end. These goals are ambitious – especially for the city banks. Equally challenging will

* For a discussion of findings from the trip regarding the Chinese economy, please see issue number 2007-06 of the *FRBSF Economic Letter* (March 9): *http://www.frbsf.org/publications/economics/letter/2007/el2007-06.html*

be how the government decides to resolve or recapitalize the last remaining unrestructured large state-owned commercial bank, the Agricultural Bank of China.

Banking sector policy initiatives move forward

In early November 2006, the Chinese government enacted new regulations governing foreign banks' operations in China. The most significant change is a new requirement that foreign banks must establish locally incorporated subsidiaries if they wish to offer most renminbi retail banking services, such as credit cards, and accept retail renminbi deposits. The impact on foreign banks could prove mixed. While large, well-established foreign banks will likely meet the new standards, new foreign bank entrants may find the standards too onerous to compete effectively in the market.

This month, the central government convened a high-level National Finance Work Conference. The participants, which included Premier Wen Jiabao and other ranking members of the government, discussed policies that would further deepen financial reform and promote financial sector development. Premier Wen's key-note speech set the framework of the policies to be taken by highlighting the following areas: restructuring the Agricultural Bank of China in line with past efforts to improve the other large commercial banks; reorganizing the policy banks as commercial banks starting with the China Development Bank; facilitating the provision of financial services to rural areas; exploring new avenues to invest China's foreign exchange reserves; promoting capital market development; allowing for the steady opening to foreign participation in financial services; and improving the coordination of financial supervision and regulation across agencies.

Capital markets are still developing

China's equities markets registered important gains last year. From end-2004 to June 2005, the Shanghai index fell 16 percent – the worst performance in Asia – but in 2006 the Shanghai exchange was the best-performing major market in Asia.

Reform of China's share class system has served as a major impetus for share price performance. Until 2005, up to two-thirds of the shares of listed companies in China were classified as "non-tradables," meaning that they could be traded only over-the-counter among legally qualified entities and not on the exchange. Previous attempts to release non-tradables on exchanges precipitated pronounced market slumps drawing heavy criticism from domestic investors. Unlike past attempts, the most recent reform measures introduced in April 2005 have faced less shareholder resistance by providing compensation to owners of tradable shares for possible price declines due to the conversion of non-tradeable shares to tradeable status. As a result, by September 2006, companies representing roughly 85 percent of the mainland exchanges' market capitalization had completed non-tradable share reform. Due to the recent strong market performance, an increasing number of large domestic firms are looking to list shares on the Shanghai exchange. Previously, most of China's better established companies listed only in overseas markets such as Hong Kong, New York and London.

Despite the progress made in reforming non-tradable shares, mainland equities markets remain significantly undeveloped by Asian standards. In 2004, only 3 percent of funds raised by companies came from the mainland's equity and debt markets. Several factors have hindered development of Chinese equity markets: (1) China's institutional investor base is small; (2) capital account restrictions remain, placing strict limits on foreign investment; and (3) few private firms are listed. It will likely take years for China to catch up with the equities markets of other Asian countries with similar income levels.

China's bond market is the largest in Asia-ex Japan in absolute terms but one of the smallest when measured as a percent of GDP. In 2005, the average ratio of outstanding bonds as a percent of GDP for other Asian economies excluding Japan was 54.6 percent compared to 28.6 percent for China. The Chinese bond market is dominated by government bonds (including central bank sterilization bonds) with corporate bonds constituting less than 3 percent of the market. A major reason for the dearth of corporate bonds lies in a system that subjects corporations to a lengthy process involving multiple approvals from disparate government agencies. Additionally, corporate bonds are subject to government-set coupon ceilings, preventing adequate risk pricing to attract investor interest.

More rapid change ahead?

So far, the government has focused most of its attention on the large banks, and secondarily on the stock market. While both will likely remain high priorities for regulators and political leaders, the rural banking sector, where NPLs are high, could see new reform efforts. Another possible force for change is the opening of the banking sector to foreign institutions in line with China's WTO commitments. The resulting increased competition could accelerate the pace of change in China.

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