GOVERNMNET'S ROLE IN THE REFORM OF BANKING SYSTEM: EVIDENCE FROM CHINESE STATE-OWNED COMMERCIAL BANKS

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ABSTRACT

We review the commercial banking system reform in China and show that the approaches taken by the Chinese government have been quite successful. Using multiple mechanisms such as capital injection, disposal of non-performing loans, preferential interest rate, tax incentives and foreign strategic partners, Chinese government has successfully converted three major banks in China from state-owned enterprises to market-oriented stock companies. Our estimation shows that the equity interests held by the government in these three banks have greatly outweighed the cost of restructuring and the loss incurred in restructuring these banks. Although Chinese banks still lack experience in corporate governance, risk management and product innovation, they have presented a unique approach of banking system reform.

Keywords: Chinese banking system; Bank reform; Non-performing loans; Role of government

Chinese financial system is largely a bank-driven system. The four major banks: Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC) and China Construction Bank (CCB), hold more than 50% of the national deposits and over 50% of the loan business. These four banks have played instrumental roles in the growth of Chinese economy; however they had also large amounts of bad debts and experienced severe operation inefficiency. Around 1990s, all four banks were on the verge of bankruptcy (Song,2000). Banking system reform became inevitable in order to secure the market stability. Starting from 1994, Chinese government started to reorganize these banks through financial restructurings and capital market operations. The highlights of the banking system reform have been the successful IPOs of three major banks. The experience of ICBC, BOC and CCB suggests three interesting solutions to banking system reform: (1) effective government intervention, (2) successful use of capital markets and (3) adoption of bank-specific approach.

The most interesting aspect of the reform is the unique approaches applied to different banks. Three of the four major commercial banks are now publicly traded corporations. Specifically, BOC and ICBC were transformed into Corporations in its entirety. CCB was broken into one banking entity (China Construction Bank Corporation) and one non-banking entity (China Jianyin Investment Corporation). The reform of ICBC was co-sponsored by the Ministry of Finance and the government investment company called Central Huijin Investment Corporation (Huijin). BOC is solely sponsored by Huijin. The marketization of CCB involves five entities including Huijin, Jianyin and etc. Between 2004 ad 2005, Huijin injected over $60 billion in the process of restructuring the above three banks. Furthermore, banks also formed strategic partnership with various foreign banks in U.S., Europe and Asia. Finally, the process of IPO also differed for these banks. ICBC cross-listed in Shanghai and Hong Kong simultaneously; BOC and CCB were initially traded in Hong Kong and then returned to mainland China.

In this article, we review the reform of the four major State-owned commercial banks and examine the government's role in the banking system reform. Part II of the paper describes how Chinese government restructured these banks through government intervention. Part III evaluates the effectiveness of China banking system reform from the perspectives of the government and the banks. Finally, Part IV concludes with our final thoughts and some policy recommendations.

II. Government's Role in the Banking System Reform

1. Capital Injection

Prior to market reform, all state-owned commercial banks in China were solely owned by the Chinese government and initial capital was funded by the government as well. Meanwhile, all profits and losses were seized by the government. Due to limited funding channel and poor operation performance, these commercial banks traditionally had very low capital adequacy. Starting from 1998, the government had injected capital both directly and indirectly into these banks. In 1998, MOF issued 270 billion Yuan treasury notes and the proceeds were use to augment the capital reserve of these banks. In 2003, the government established Central Huijin Investment Corporation based on the investment of the foreign exchange reserves by State Administration of Foreign Exchange. Huijin becomes the most important vehicle for the government to inject new capitals in state-owned commercial banks. Two weeks after its origin, Huijin injected $45 billion in BOC and CCB. In 2005, Huijin provided $15 billion for ICBC. The government also encouraged these banks to raise capital through issuing new stocks, bonds and establishing strategic alliances with foreign banks. In 2005, CCB went public on Hong Kong Stock Exchange and raised HK$71.58 billion through IPO. Two years later, CCB raised another 57.1 billion Yuan through an IPO offer in Shanghai Stock Exchange. In 2006, BOC raised 20 billion Yuan in mainland China and HK$86.7 in Hong Kong. Finally, ICBC offer both A and H shares on Oct 27th, 2006 and became the largest IPO globally. It raised HK$124.9 in Hong Kong and 46.4 billion Yuan in mainland China. In addition to equity offerings, government also announced several guidelines to facilitate the securitization of sub-prime long-term loans held by these banks. By the end of 2006, the debt issued by BOC, CCB and ICBC approximated 16.28

billion Yuan. The last source of capital came from foreign strategic investors. Chinese government approved a list of Foreign Institutions and provided great incentives for them to work with Chinese banks. Meanwhile, each Chinese bank was encouraged to seek foreign partners to boost its capital reserve. For example, BOC teamed up with Bank of Scotland, CCB partnered with Bank of America and ICBC aligned with Goldman Sach. The investment of foreign partners totaled more than 106 billion Yuan. The details of funding amount are reported in Table 1 by bank and by sources. We can see that capital increased by over 1422 billion Yuan. For three listed banks, the amount of capital injection exceeded 400 billion for each bank.

Table 1 Capital Injection through Different Sources in billions of Yuan

	Treasury Note	Huijin	Foreign Partners	IPO: Shanghai	IPO:Hong Kong	Debt Issuing	Total
ICBC	85	124.0	30.5	46.6	126.6	35	447.7
BOC	42.5	186.4	43	20	90	60	441.9
CCB	49.2	186.2	32.8	57.1	74.6	40	439.9
ABC	93.3						93.3
Total	270	496.6	106.3	123.7	291.2	135	1422.8

Source：Okazaki (2007) and Banks' Annual Reports

2. Disposal of Non-Performing Loans (NPLs)

One of the overhanging problems for State-owned commercial banks was the colossal amount of non-performing loans. In 1999, the ratio on NPL to total loans for State-owned commercial banks was up to 40% and it was still over 20% ($232 billion) in 2003(Yuan and Zhao,2007). Effectively, there were three rounds of NPL disposals since 1994. The first round took place in 1994 when State-owned commercial banks disposed their NPLs to three newly formed policy banks: China Development Bank, Export-Import Bank of China and Agricultural Development Bank of China. For instance, by the end of 1994, ICBC, ABC and BOC disposed over 356 billion Yuan of loans to the Agricultural Development Bank of China. The second round of disposal happened in 1999 and four asset management companies (Orient Asset Management, Great Wall Asset Management, Cynda Asset Management, Huarong Asset Management) were created to absorb the NPLs for different banks. All together, the four major banks disposed over 1,294 billion Yuan of NPLs to the four asset management companies. By the end of 2006, the above four asset management companies unloaded 866.34 billion Yuan of NPLs and collected 180.56 billion Yuan. After the disposal of NPLs to asset management companies, the balance sheet quality for banks improved greatly. However, these banks failed to improve their operating efficiency and new loan quality, NPLs rose again to the original level just after a few years. The final round of NPL disposal took place prior to the IPO of these commercial banks. The three banks that raised capital though public offerings disposed 1162.8 billion Yuan of NPLs to government sponsored asset management companies. Clearly, Chinese government played a crucial role in disposing the NPLs of its major commercial banks. The first round of disposal mainly dealt with NPLs created by the government economic policy prior to its adoption of market economy. It is only fair for the government to step in and absorb those NPLs. However, the government should not be responsible for the increasing NPLs completely in the second and third round of disposal. Operation inefficiency, low management quality, incompetent personnel, weak protection of debt-holders and etc have all contributed to the drastic increase of NPLs (Zhou,2005). In order for these banks to go public with a clean slate, the government stepped in and assumed more than the fair share of their responsibility.

3. Policy Support

The banking system reform was led by the Chinese government and supported by various government agencies and regulatory bodies. In 2002, State Council of the People's Republic of China formed a team to lead the reform of State-owned commercial banks. In 2003, the decision was made to convert exiting banks into publicly traded corporations. Many policies and rulings were made, and new agencies (including Huijin and AMCs) formed to support banks' effort in raising capital reserve and lowering NPLs. In 2007, National People's Congress approved the proposal of issuing 1,550 billion Yuan Treasury notes to establish China Investment Corporation(CIC) that became the parent company of Huijin. From the beginning of the banking system reform to the IPOs of thee major banks, the government had created favorable policies and provided various incentives to facilitate the transformation of its financial system. The government also provided direct support through its tax policy and interest rate policy. In 1997, the government lowered the income tax rate for all State-owned commercial banks from 55% to 33%. However the business tax was raised from 5% to 8%. In 2001, the government began to take steps to reduce the business tax, and it returned to 5% in 2004. A recent proposal was to further reduce the business tax to 2% and eventually removing it (Tian,2006). Tax reduction was also awarded to major commercial banks. For example, CCB received a tax reduction of 15.74 billion and 7.85 billion in 2004 and the first half of 2005.

Another effective policy support was the interest rate policy. For a long period of time, commercial banks in China were only allowed to lend and borrow using the government approved rate. The requirement was then relaxed to allow lending rate to float within the range allowed by the central bank. Starting from October 2004, commercial banks in China were allowed to lend at 10% below the published rate and the ceiling for the lending rate was removed. The difference between the published one-year deposit and lending rates has been kept above 3.33% after 1999. This is relatively larger than the rates in developed countries and it helps to ensure a higher profit margin for commercial banks in China. The favorable interest rate policy ensured net interest margin and the ratio of net interest revenue for BOC, CBC, ICBC to maintain between 2% and 3% between 2003 and 2007.

III. Effectiveness of Chinese Banking System Reform

1. Positive results for the Government

The Chinese government has directly and indirectly funded the banking reform through many rounds of capital injection, NPL disposals and a series of favorable policies. However, the government has maintained absolute control of these publicly traded commercial banks after their IPO. If we examine the holdings of the government in the three banks as shown in Table 2, we see that the total market valuation of the holdings adds up to 4509.48 billion Yuan (3952 billion Yuan above the book value).

Table 2 Ownership of Listed Banks by the Chinese Government

Bank	Institution	Shares (billion Yuan)	Book Value (Yuan/Share)	Total Cost (billion Yuan)	Market Price (Yuan/share)	Market Cap (billion Yuan)	Premium (billion Yuan)
ICBC	MOF	124	1.00	124	8.13	1008.12	884.12
	Huijin	124	1.00	124	8.13	1008.12	884.12
BOC	Huijin	171.325	1.00	171.325	6.61	1132.46	961.13
CBC	Huijin	138.15	1.00	138.15	9.85	1360.78	1222.63
Total		557.475		557.475		4509.48	3952

Source: IPO prospectus. Market Capitalization is based on the 2007 last trading day price of A share.

The expense incurred by the government mainly includes the following: 1) 270 billion Yuan capital injection in 1998; 2) investment of $60 billion (496.6 billion Yuan) by Huijin; 3) cost of disposing 2456.8 billion Yuan of NPLs (conservatively we estimate the cost might run up to 2000 billion Yuan). The total cost adds up around 2,770 billion Yuan, 1,800 billion Yuan less than the total premium in the value share ownership. The simple calculation (ignoring indirect holdings of Huijin) suggests that the government have earned significant premium in the process of banking reform. However, it is worth noting that the positive outcome relies heavily on the favorable market price of these banks.

2. Improved Performance for Listed Banks

Two important outcomes of the banking system reform are the higher capital adequacy ratio and lower NPL ratio. Prior to 1998, none of the four major banks met the minimum capital adequacy ratio of 8%. After the reform, the capital adequacy ratio for three listed banks all surpassed 12% in 2006. The NPL also dropped significantly for all three listed banks. For example NPL ratio for CCB went from 16.97% in 2003 to 2.95% in June 2007, and NPLs for BOC and ICBC were 3.56% and 3.29% in June 2007. Meanwhile, the listed banks also learned from their foreign partners and went through organizational changes to manage risk exposure, optimize operation, offer new products and improve efficiency. Tools such as risk adjusted return on capital and economic value added were applied to measure bank performance. Return on assets (ROA) and return on equity (ROE) also improved for listed banks. Due to the financial restructuring and the policy support, three listed banks earned 11-14% ROE in the third quarter of 2007. Table 3 presents the performance comparison among four major banks. We can see that three listed banks experienced a higher ROA and ROE after they became stock companies.

Table 3 **Performance for Major Commercial Banks** %

Name	Performance	2003	2004	2005	2006	2007
ICBC	ROA	0.49	0.61	0.59	0.66	0.74
	ROE	-4.20	-6.17	14.51	10.47	12.14
BOC	ROA	0.80	0.59	0.69	0.89	0.83
	ROE	13.90	10.85	12.41	11.29	11.10
CBC	ROA	0.01	1.25	1.03	0.85	0.89
	ROE	0.22	25.08	16.37	14.03	14.64
ABC	ROA	0.06	0.05	0.02	0.11	-
	ROE	1.39	2.57	1.31	6.91	-

Source: Wind Database and Bankscope.

IV. Conclusions

Generally speaking, the banking system reform in China has been successful and all participants have reached the win-win outcome. The experience for the three listed commercial banks can serve as models for other banks ready to follow suit. ABC, joint-stock commercial banks, urban commercial banks, rural credit unions and many other financial institutions can derive their unique approaches and use capital markets to achieve their goals. However, it is worth noting that government control remains strong even for listed banks. To improve corporate governance and operation efficiency, the government needs to gradually relax its control and allow the market to be the dominant force in the banking system. Huijin and government sponsored investment companies have earned significant premium due to favorable market conditions, but shares held by these institutions are still in the lock-up period and are not freely traded yet. The uncertainly in future stock market can have a huge impact on the outcome of the ongoing banking system reform. As for commercial banks that have successfully gone through the IPO process, there is no guarantee that future performance will continue to improve (García-Herrero, Gavilá and Santabárbara, 2005). Moving from a government-sponsored banking system to a market-driven operation, banks need to go through significant changes internally. Globalization has provided Chinese banks great opportunities to learn from their strategic partners; meanwhile it also poses a great challenge for Chinese banks to compete with foreign banks that are more experienced and technologically sophisticated. The banking system reform is not yet complete and Chinese government needs to vigilantly monitor the economy and the banking system to meet any new challenges.

References available upon request from Qinghua Song