China’s Banking Reform in the Context of Globalization and Transition

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Introduction

This article examines recent reform of China’s state-owned commercial banks (the “big four”) in the context of globalization and China’s transition to a market economy.¹ Specifically, the critical issues of NPL (non-performing loan) disposal and the preparations of the “big four” for overseas listings are under close investigation.

As a special type of SOE (state-owned enterprise), the reform of the “big four” is by nature aimed at solving the same problem as China’s SOE reform has targeted: state ownership and its costs. There exists strong complementarity between China’s SOE and banking reforms, primarily because the “big four” are the principal lenders to SOEs while SOEs are the main contributor to the NPL problem in the banking sector. Accordingly, the success or failure of the “big four” in the wake of a new round of reforms in China’s banking sector since late 2003, including foreign exchange reserve injections, shareholding restructuring, corporate governance reform and overseas listings, will ultimately affect the results of China’s SOE reform. In addition, China’s banking reform also has a significant impact on the country’s buoyant private enterprises. Despite their remarkable performance over the last two decades, China’s private enterprises have not yet gained equal access to state bank credit as their state counterparts, thus suffering from widespread capital starvation that has hindered their development.

The importance of China’s banking reform for the country’s growth prospects in the era of globalization and transition cannot be understated. Specifically, if China’s banks cannot eventually operate on a commercial basis and become independent of government intervention in their lending decisions, even a successfully implemented privatization scheme will not bring global competitiveness to Chinese enterprises. Examples of politically-directed loans to private firms as beneficiaries of government favouritism abound when one looks to Japan, South Korea, and Latin America where bank crises resulting from government encroachment have not been an uncommon phenomenon. In this regard, ownership reform alone is not

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¹ The “big four” banks are Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BoC) and Agricultural Bank of China (ABC).
a sufficient condition for China to transform its SOEs into modern enterprises that can perform and compete in the global economy. Replacing the soft budget constraints on SOEs with hard budget constraints is also necessary, and this cannot be achieved without a successful transformation of the “big four” from state-dictated credit allocators to modern commercial lenders.

Given these broad implications, this article argues that as China is increasingly integrating itself into the global economy, its banking reform must proceed swiftly and decisively and address some of the most difficult and politically challenging issues, such as considerably reducing state ownership and introducing foreign and private capital in the banking sector. As China’s SOEs are currently implementing an accelerated privatization scheme on a much wider scale under the “grasping the large, releasing the small” (zhuada fangxiao) policy, and the stock market has also come to a turning point of reform by tackling the problem of a split share structure, corporate governance reform of the banking system carries great weight for the health and stability of China’s overall economic structure. In terms of effective reform strategies, shareholding restructuring and overseas listings would provide China’s state banks with improved governance mechanisms and incentive structures, as well as international management skills and much stricter commercial discipline.

Although only a start, the reform measures that have recently been implemented in China’s banking sector, as this article reviews, are positive signs of the government’s determination to fix the country’s fragile financial system. This encouraging trend must be sustained. It has also become clear that any progress in China’s banking reform will have profound implications for the privatization of SOEs as well as the stabilization and development of the stock market. As has been pointed out by concerned observers, funds irregularly diverted from the banks to the stock market for lucrative returns is likely to pose a systemic risk for China’s entire financial sector. Therefore, the structural reforms of the banks, SOEs and the stock market should proceed hand in hand to gain synergies and complementary support from one another. Failing that, it will be impossible for China to successfully complete its transition to a market economy.

I. The NPL Problem and the Urgency of China’s Banking Reform

China’s “big four” state banks have dominated the country’s credit allocation process. Having been under control by the state to channel funds to SOEs for years, they are unable to price loans properly and allocate capital efficiently. As a result, they are stranded in a minefield of bad loans. Given the government’s plan to sell off minority stakes in the “big four” to international investors through their overseas listings, the task of fixing the NPL problem is formidable: according to an estimate by UBS, to bring these banks into a “saleable” condition, the minimum amount of government NPL carve-out is RMB 2.4 trillion, or 21 percent of GDP.²

1. The Severity of the NPL Problem

Compared to the small capitalization of China's stock market, the banking system collects an overwhelming portion of China's domestic savings, which is equivalent to nearly 40 percent of GDP. At present, nearly 90 percent of household savings are held in deposits with state-owned banks, partly because of the lack of alternative investment channels. Unfortunately, the banks misallocate these funds on an even grander scale than China's stock market, whose dysfunction and inefficiency in disciplining listed companies and rewarding good corporate governance is widely recognized by both domestic and international investors.

The "big four" in combination account for the lion's share of the NPLs in the entire banking sector, which go as high as USD 400 billion. The poor operational quality of the "big four" and their discrimination against private enterprises are widely known. For example, the "big four" direct 80 percent of their lending to generally unprofitable SOEs. The purpose is to prevent unemployment and the loss of welfare benefits to former and current SOE employees. By comparison, the vibrant private sector, which has been the main driving force of China's economy and created around 40 million new jobs during the period of 1998–2003 alone, is largely left to seek self-financing. McKinsey Global Institute notes that private and foreign-owned enterprises generate 52 percent of GDP, but are receiving a mere 27 percent of bank credit. In order to achieve growth and expansion, most of China's private enterprises rely on retained earnings, foreign capital, or informal sources of expensive credit.

2. The Causes of NPLs

According to empirical studies by Chinese economists and working reports of China's central bank, the causes of NPL creation are multiple and not all of them are attributable to the state's intervention. In general, both the "ownership effect" and the "size effect" have an impact on NPL generation at the "big four." The "ownership effect" usually leads to state intervention in banks' lending decisions and for that matter the accumulation of policy loans. The "size effect," on the other hand, implies that the "big four" are indeed too big to manage their business ef-

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6 Take the example of the ICBC, China's largest lender: in 2003, it reported around 100 million depositors and 24,000 branches, plus USD 638 billion in assets, or 19 percent of the Chinese banking system total. See "China's Biggest Lender is Ripe for December Recapitalization" Asian Wall Street Journal (23 December 2004) M.1.
ficiently when the command chains are multiple under their traditional five-layer organizational structure, whereby it is difficult for orders from the headquarters to reach the ground level of local branches and be implemented precisely. Understandably, the agency problem caused by information asymmetry between the state owner and bank managers is particularly severe at the “big four,” which makes measuring performance difficult.7

The governor of the central bank, Zhou Xiaochuan, provided some reliable statistics on the causes of China’s NPLs. According to his work report released in May 2004, the causes of NPLs can be roughly divided into the following five categories:8

1. Direct administrative orders and intervention at various levels of Chinese government, primarily the local governments, are responsible for 30 percent of NPLs;
2. Another 30 percent is caused by banks’ routine lending practice of supporting SOEs;
3. Local legal and administrative environments explain a portion of 10 percent;
4. Another 10 percent is a result of the adjustment of China’s industrial structure organized by the central government during the country’s transition, and
5. The remaining 20 percent can be attributed to banks’ own mismanagement and business losses.

Interestingly, in a separate study a senior Chinese banking regulator reveals that “poor local credit environments” are the primary variable of NPLs, which account for almost 70 percent of NPL creation, while government ownership and mismanagement of bank officials can only explain the remaining 30 percent.9 This in turn raises the question of what has caused the poor local credit environments, and the answer relates to the role of local governments in promoting regional economies under existing performance evaluation system for government officials. The chief problem lies in the central government’s over-emphasis on “GDP growth” related indicators with regard to measuring, and subsequently rewarding, the performance of local government officials. This sheer preference for the single dimension of GDP growth occurs at the expense of sacrificing other important institutional yardsticks, such as protecting the property rights of local enterprises and establishing a healthy local credit environment. It is telling that the fastest growing local economy

7 Ye Weiqiang, “Professor Yi Gang on the Breakthrough in the Thoughts about China’s Banking Reform Strategy” Caijing 72 (20 November 2002) [Ye].
in China, the Guangdong province, is also the most affected “disaster area” for financial failures. Almost all of the recent high profile bank scandals happened in Guangdong and the province’s average NPL ratio is one of the highest among China’s localities.\textsuperscript{10}

Other frequently cited causes of NPLs include the personnel and compensation mechanisms at China’s state banks, which usually link the qualifications for senior management positions to political considerations and link lending decisions to the size, not the quality, of loans. For all these characteristics, the “big four” act more like government agencies, not commercial institutions.\textsuperscript{11}

It is worth noting that examining the actual causes of NPLs is critical to obtaining a better understanding of the “transition costs” in China’s financial system. This issue is discussed in Section III where the debate over “who should bear the transition costs” of China’s banking reform receives close attention.

3. The Urgency of Banking Reform

Because banks are the weakest link in China’s fast growing economy, success or failure of reforms of the banking sector could have broad international repercussions, given the fact that China has now become an important driver of global growth. Chinese state banks have traditionally measured success by the size of their loan portfolios, and the central task of banking reform is to change that to an operational culture based on profit.\textsuperscript{12} In a widely shared opinion of many domestic and foreign experts, delayed banking reform could eventually threaten a collapse of China’s entire financial system and severely undermine the growth trend of China’s economy.\textsuperscript{13}

In this connection, it is worth reviewing the relationship between financial crises and economic growth. Recently, a new strand of the “finance and growth” theory has emerged to suggest a “re-evaluation” of financial crises and growth.\textsuperscript{14} According to this new study, cross-country empirical evidence indicates a robust link between occasional financial crises and faster GDP growth. The proponents of this “re-evaluation” of financial crises and growth argue that occasional crises can be welfare-improving when the benefits of higher growth outweigh the welfare costs of crises under some circumstances.\textsuperscript{15} In theory, in an economy with severe credit market imperfections, the adoption of credit risk is a means to overcome the obstacles to growth by easing financing constraints. However, as a side effect

\textsuperscript{10} Ibid.
\textsuperscript{11} Ye, \textit{supra} note 6.
\textsuperscript{13} Ibid.
finance fragility arises and thus crises occur from time to time. Therefore, there exists a trade-off between financial fragility and economic growth, that is, "no fragility, no growth."\footnote{16}

However, this positive link between financial fragility and growth does not fit in well with China’s situation. The potential systemic crisis of the entire financial system that a spectacular bank failure could engender is too devastating a scenario to imagine. It could severely impair the stability of China’s economic structure and cause chain-reaction collapses in all sectors involved. Therefore, China’s “big four” are in an urgent need of reform, before a systemic crisis erupts and dampens the growth prospects of China’s economy in the future.

Moreover, China agreed as part of its WTO commitments to remove geographical and product restrictions on foreign banks and allow the full opening of its banking sector in December 2006. This pressure of imminent financial liberalization adds even more urgency to the long delayed banking reform. And there is the looming challenge of a fast-forming “grey/aging population,” to arrive in just 15 or 20 year’s time.\footnote{17} The aging population problem would make China’s future pension liabilities a formidable financial burden, and the banks’ health is a crucial factor in meeting that challenge.

II. AMCs and NPL Disposal


A. The First Transfer of NPLs from the “Big Four” to AMCs (1999)

During 1998, four asset management companies (AMCs) were established by the Chinese government to help dispose of the estimated USD 500 billion in NPLs that have plagued China’s banking system. The four AMCs are China Huarong Asset Management Corp. (Huarong), China Great Wall Asset Management Corp. (Great Wall), China Orient Asset Management Corp. (Orient) and China Cinda Asset Management Corp (Cinda). Each AMC is responsible for dealing with NPLs of one of the “big four.”

Over the following couple of years the government transferred, at face value, roughly USD 170 billion of bad loans from the “big four” to their respective AMCs, equivalent to more than one fifth of the banks’ loan books. The loans were almost all made before 1996, and most of them were policy loans without collateral.\footnote{18} The Chinese government then warned the banks that the transfer of NPLs was their “last supper,” which was later proven to be wishful thinking as the “big four” were to get more free meals in the ensuing several years, as Section III reports.

\footnote{16}{Ibid.}
\footnote{18}{“Casino Capital”, supra note 4.}
B. The Second Transfer of NPLs from the BoC and CCB to Cinda (2004)

In June 2004, to help both CCB and BoC accelerate preparations for their overseas listings, the central bank and the Treasury organized another transfer of NPLs at the two banks, valued at RMB 278.7 billion yuan (USD 33.62 billion), to Cinda. The price paid by Cinda was a 50 percent discount of the book value. The purpose of this move was to make the books of both CCB and BoC look much healthier before they could invite external auditors to review their major financial indicators in order for the shareholding restructuring to take place, which was a necessary prior step to their overseas IPOs. As a result, both banks reportedly achieved a reduced NPL ratio of below 5 percent.

2. The Implementation and Effect of NPL Disposal

A. The Implementation of NPL Disposal

Until recently, the disposal of NPLs had generally been a cumbersome process. First, the “big four” transferred the NPLs at face value to the AMCs because the banks themselves were prohibited by China Banking Regulatory Commission (CBRC) to directly sell NPLs at below face value. The AMCs then recovered those bad loans or sold them to foreign bidders through auctions. In such auctions, the major buyers are international investment banks. In order to participate in the NPL disposal process, it is usually necessary for these foreign banks to form asset management joint ventures with China’s AMCs.

There have been several auctions of NPL portfolios to foreign banks. In 2001, a consortium of Wall Street firms led by three U.S. investment banks, of which Morgan Stanley was the largest shareholder, bought a portfolio of NPLs with a face value of USD1.3 billion from Huarong in China’s first international NPL auction. In February 2003, Goldman Sachs also sealed a joint venture purchase with Huarong for a package of NPLs valued at 1.9 billion yuan (USD 229 million). In March 2003, after having established a similar asset management joint venture with Huarong, a Morgan Stanley-led consortium received final regulatory approval to buy 10.8 billion yuan (USD 1.3 billion) of Huarong’s NPLs, which marked the largest such portfolio sale of NPLs in China’s history. Most recently, as of January 2005 Great Wall was in the process of auctioning its remaining unrecovered NPLs, valued around RMB 150 billion yuan (USD 18 billion).

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22 Ibid.
To break the monopoly of AMCs in NPL disposal, the banks themselves have tried to enter this business by devising new methods that would circumvent the CBRC's prohibition on their selling NPLs at below face value. For example, in February 2004 CCB planned to pioneer a new type of distressed asset auction as it raced to become the first of the "big four" to launch an overseas listing. Instead of selling NPLs, CCB hoped to first separate the loan from its collateral and auction the collateral, in this case worth RMB 5 billion (USD 600 million). Meanwhile, the BoC also planned an auction that would circumvent the AMCs and offer NPLs with a face value of about RMB 6 billion (USD 724 million) to foreign and domestic bidders directly. If permitted by the CBRC, these new approaches of the "big four" to splitting the market share of NPL disposal business would bring competitive pressure on the AMCs.24

B. The Effect of NPL Disposal
In general, the effect of NPL disposal has not been encouraging, at least seen from the quick accumulation of new NPLs at the "big four" after the 1999 bail-out.

Officially, according to the China Banking Regulatory Commission, which oversees China's commercial banks and major financial institutions, the bad loans at the "big four" stood at a reduced total of 1.575 trillion yuan (USD 205 billion) and the banks' average NPL ratio dropped to 15.6 percent at the end of 2004.25 The CBRC regarded this as a good sign and praised the banks for a "double reduction" in major NPL indicators.

However, while China's financial regulators may have stepped up their efforts to clean up the existing stock of NPLs, the country's banking system has yet to deal with another source of instability - new bad debt.26 Moreover, the official figures are not credible and the true level of NPLs is certainly much higher for reasons discussed below. Independent studies have found far more worrying results as compared to the government's statistics. For example, according to the estimate of UBS, even after the write-off of bad loans by the central bank and the transfer of bad assets or bad loans to AMCs, the average NPL ratio at the "big four" still stood at a stunning 40 percent at the end of 2003.27 Besides, the AMCs have also been criticized for their seemingly low recovery rates and for selling state assets at bargain prices, in particular to foreign buyers, as will be discussed shortly. The 2004 official figures showed the recovery rate of NPLs in cash terms was only 20.29 percent, meaning that the loss rate of uncovered loans was nearly 80 percent.28

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27 Anderson, supra note 2.
3. The Problems Involved in The Process of NPL Disposal

Some serious problems have emerged in the NPL disposal process that expose the loopholes in the current institutional design and also signal the urgent need for further vigorous reform of China’s banking sector.

A. The Moral Hazard of the “Big Four” and Fraudulent Transfers of NPLs

In the process of transferring their NPLs to the AMCs, the moral hazard of the “big four,” as typically observed with every government bail-out measure, has led them to mis-categorize their problem loans and increase the bulk of NPLs transferred to the AMCs. In some cases, in order to disguise their business losses caused by irregular transactions or even financial crimes, some bank managers forged documents to make fraudulent NPL transfers.\(^{29}\)

B. The Lack of Proper Valuation and Standardized Procedural Mechanisms in the Process of NPL Disposal

In the course of NPL disposal, there have been accusations by some domestic critics that in their disposal of NPLs, the AMCs have made “fire sales” to foreign investment banks at the expense of potential domestic buyers and China’s “national economic security.”\(^{30}\) Such accusations intensified after an international auction held in 2003 by Huarong that resulted in more than 10 billion yuan (USD 1.3 billion) of assets being acquired by six foreign investment banks, the largest NPL portfolio auction in China’s history.\(^{31}\) Public criticisms have put Huarong and other AMCs under pressure to proceed swiftly with future NPL auctions to foreign buyers.

The real question to be asked is whether the prices paid by foreign buyers in previous NPL auctions were really “too cheap” and if so what had caused the under-pricing. The answer is that the difficulty in pricing China’s NPLs properly is associated with the underdevelopment of market mechanisms for NPL disposal in China’s transition economy. After all, China’s AMCs only started the business of NPL disposal several years ago and there was no existing domestic experience from which to draw. Although NPL disposal in other countries, in particular some East Asian countries after the 1998–1999 financial crisis, has provided some valuable lessons to China, its institutional environment and still-developing market mechanisms are not mature enough for efficiently implementing NPL disposal schemes.


The first problem is that there were few domestic buyers interested in entering this market when the new business of NPL disposal first launched in China. At the beginning, few domestic institutions could imagine that NPL disposal would one day become an attractive business with potentially lucrative returns to the buyers of NPLs and simply shunned this market. Foreign banks, hoping to make inroads in China’s financial industry as the country opens up to the world, were the first active participants in NPL auctions at a time when the AMCs started to experiment with market-oriented schemes to dispose of the NPLs they had acquired from the “big four.” Therefore, the initiating market players in China’s NPL disposal, on the demand side, were international investment banks.32

The second problem is that while it is likely that the prices paid by foreign buyers were indeed “too cheap,” the primary reason for the under-pricing is the lack of proper valuation system and standardized auction procedures for NPL disposal in China, such as information disclosure, property documents authentication and risk assessment. Besides, there are regulatory hurdles regarding government approval, which usually result in uncertainty and delay and this factor certainly has a negative impact on NPL pricing.

Aware of these institutional inadequacies, the CBRC has been stressing the need to both improve the capacity of China’s AMCs in handling NPL auctions more effectively and to develop necessary market mechanisms to facilitate NPL auctions. As to the participation of foreign buyers, the CBRC is positive about the overall beneficial impact brought by their expertise and experience, and encourages the AMCs to continue to cooperate with foreign players.33

C. Irregular Dealings and Corruption at AMCs

Adding to the already depressing problems of continuing generation of new NPLs at the “big four” and the low recovery rates at the AMCs, recently it has also been discovered that in the process of NPL disposal, irregular dealings have occurred on a wide scale, some involving corruption and embezzlement by the personnel at both the AMCs and the “big four.”34 Specifically, in a 2005 work report of China’s National Audit Office, 38 cases of illegal practices at the four AMCs, valued at 6.7 billion yuan (nearly USD 846 million) were identified.35

32 Wu & Su, supra note 27.
35 Brown, supra note 21.
4. Summary

From the discussion of NPL disposal so far, it can be seen that the operational effect of AMCs is subject to both public criticism and government scrutiny, which will add more difficulties to redressing the alarming reality of newly-created bad loans. Therefore, to effectively solve the existing NPL problem and slow the growth in new bad loans, further banking reform measures are needed, which must go beyond continuing write-offs of bad debt and capital injections. The key component of these measures is the creation of a modern banking industry based on a strong credit scoring and risk management culture, and at the heart of this effort is the need for better corporate governance. This leads to the issue of shareholding reform and the preparations of the “big four” for overseas listings, which is dealt with in Section VI.

III. Recapitalizing the “Big Four” Through Government Bail-outs

The government has over the past several years spent huge amounts of money to bolster the capital base of the “big four,” totalling USD 250 billion. The so-called “free supper” has been offered time and again despite the government’s repeated warnings that every bail-out was the “last chance.” While the latest effort of using China’s abundant foreign exchange reserves to recapitalize the BoC and CCB in December 2003 (and eventually also ICBC and ABC in 2005) may be an innovative method with relatively lower costs compared to other bail-out options, it also entails potential risk and indeed has increased the moral hazard of the “big four.”


In 1998, the government injected 270 billion yuan (USD 32.6 billion) into the “big four” by issuing special treasury bonds, and at the same time spun off 1,400 billion yuan (USD169 billion) worth of their NPLs. As a direct result of this infusion, the capital adequacy ratio of each of the “big four” immediately reached 8 percent, the threshold required under the Basel accord. However, the four banks have again accumulated 2,100 billion yuan (USD 254 billion) worth of new NPLs as of February 2004. It seemed that the money injected failed to bring about expected performance improvement because the banks did not change their management systems and lending patterns after the recapitalization.

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36 Bekier, supra note 24.

China has a large build-up of foreign exchange reserves. In October 2004, these stood at more than USD 600 billion, about 60 percent of GDP, and are largely held in US Treasury bills. Making use of China’s rich pool of foreign exchange reserves, the central bank in December 2003 provided the BoC and CCB, the country’s second and third largest lenders respectively, each with USD 22.5 billion. This move was aimed at increasing the capital adequacy of the two banks to pave the way for their subsequent shareholding restructuring and overseas listings.

According to some approving Chinese financial analysts, the government’s decision to recapitalize the BoC and CCB with foreign exchange reserves struck “a delicate balance between financial stability and monetary stability” because in this scheme the government provided the banks with capital without worsening its budget deficit. At the same time, the money was injected through a newly created holding company, Central Huijin Investment (Huijin), which is wholly owned by the state, to allow the government to remove itself from direct ownership of the banks. Huijin’s role in the following shareholding restructuring of both the BoC and CCB is discussed below in Section IV.

After the capital injections into the BoC and CCB in 2003, China’s largest lender, ICBC, is expecting a similar bail-out in 2005. The expected capital injection would pave the way for an overseas listing worth up to USD 10 billion. According to industry estimates, the amount of ICBC’s capital injection could reach USD 45 billion. Because of its size, ICBC suffered more than any other state bank from years of policy lending. As of September 2004, its NPL ratio stood at 19.46 percent, which is described as “a scary figure for overseas investors” by Chinese bankers and is higher than China’s official average NPL ratio of 13 percent.

As to the ABC, the weakest and smallest of the “big four,” it submitted its shareholding restructuring plan to the government for review in early 2005, in anticipation of a similar capital injection. Because of the heavy burden it has long assumed to provide rural policy loans, the ABC is widely regarded as making the slowest progress in bank shareholding reform. The method of capital injection,

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38 Lal, *supra* note 3.
40 Hu Shuli, “A Double-edged Sword: On Recapitalizing Banks with Foreign Exchange Reserves” *Caijing* 100 (20 January 2004) [Hu].
41 “China’s Biggest Lender”, *supra* note 37.
however, is still uncertain with regard to the ABC, because the Treasury, as the owner of the “big four,” has recently expressed discontent about being overshadowed by other government agencies, primarily the central bank, in China’s latest banking reform moves and wants to regain a leading profile by orchestrating the next round of capital injections and providing the money itself. Regardless of the method of capital injection, however, it is the government – with taxpayers’ money – which ultimately bears the cost.

3. **Write-Off of Bad Assets (The Forgiveness of Owner’s Equity Claims of the Treasury): 2004**

After receiving the capital injection of foreign exchange reserves, the BoC and CCB again were offered another free meal. In January 2004, the Treasury announced that it would use its owner’s equity claims in the two banks, worth RMB 300 billion (USD 36.2 billion), to write off their bad assets. This was viewed within Chinese financial industry as the government paying for the historical losses of the state banks out of its own coffers, for which Chinese taxpayers ultimately paid.

4. **The Problems Associated with Repeated Bail-Outs**

   **A. The Moral Hazard of the “Big Four” and other Financial Institutions in Anticipation of “Free Suppers”**

   For all its innovation, the approach of using foreign exchange reserves for bank capital injections has been criticized by some economists. The first problem is obvious: it could cause moral hazard not only at the “big four,” but also other financial institutions currently operating with dismal capital bases, especially when government bail-outs of troubled financial institutions seem to have become a repeated exercise.

   In the latest round of bail-outs, it appeared to some that injecting foreign exchange reserves into state banks is a low-cost method in comparison with other options. As a result, not only the “big four,” but also other troubled financial institutions have come to believe that the government has found a new mechanism to save them. An appalling fact emerging from the lower levels of China’s financial industry is that an army of 112 city commercial banks and 35,544 rural credit cooperatives is lining up for a “blood infusion” by the government, with their capital adequacy and NPL ratio even worse than that of the “big four.” However, China’s foreign exchange reserves, ample as they currently are, are not unlimited. With an illusion about a deep treasury box, the “big four” will not cherish the capital they have received as much as they should, and will expect more “free gifts” from the

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government as they proceed with further reforms.46

Indeed, in analyzing the actual effect of repeated bail-outs, the unavoidable conclusion is that money spent on recapitalizing China’s banks over recent years did not result in evident performance improvement. Since 1998, China has spent roughly USD 200 billion in recapitalizing its banks and writing off bad loans, to little avail. Politically directed lending to favored enterprises, especially those in the “strategic sectors,” has continued as before, and the previous write-off of bad assets was soon replaced by new ones. According to China’s official statistics, at the end of 2004 NPLs stood at USD 205 billion, or 13 percent of total banking assets. Some independent estimates put the level of NPLs at around USD 420 billion, or nearly 40 percent of GDP.47

B. The Potential Risks to The Stability of The Financial System

The second problem is the potential risks of using foreign exchange reserves to recapitalize the “big four” to the stability of China’s financial system. Having sufficient foreign exchange reserves is usually an important indicator of a country’s financial safety, and it is commonly understood that these funds should not be used on illiquid projects, such as strengthening the “core capital” base of state-owned commercial banks. Besides, some Chinese economists also believe that the capital injection of foreign exchange reserves will eventually harm the central bank’s independence and regulatory credibility.48

In this regard, it is interesting to note that a veteran development economist and long time China observer, Deepak Lal, has sketched an ingenious scheme for better using China’s vast foreign exchange reserves to help with the reform of both the country’s banks and SOEs:

... There is a better way for China to use its reserves. At most, only a small proportion – say Dollars 100bn – is needed to fend off any speculative attack in order to maintain the dollar peg. The rest – some Dollars 500bn, as well as any future accruals – could be put into a social reconstruction fund under the central bank. This would function like any other big pension fund, such as that for the World Bank, whose annual return, averaged over 10 years, has been about 8 percent. If the proposed fund for China could match this, it would yield an annual income of Dollars 40bn, or 4 percent of GDP, which could be used gradually to cover the SOE’s social burdens [now largely funded by the state banks]. The SOEs could then be treated as normal enterprises, to be privatised if viable and closed down if not... In time, as the SOE problem receded, the income from the fund could become the basis for a fully funded pensions system for China’s ageing population...49

46 Hu, supra note 38.
47 “Beyond a Bail-out”, supra note 12.
48 Ye & Lu, supra note 35.
49 Lal, supra note 3.
This suggestion seems reasonable and is tailored to the current situation of China’s currency regime, financial development, pension liabilities and SOE reform. Therefore, this new idea warrants consideration in the next stage of China’s banking and SOE reforms.

5. The Debate over “Transition Costs” and “Paying for a Modern Banking System”

A. “Transition Costs”: Who Should Pay for Them?
It is worth noting that in the process of China’s banking reform, an intense debate has taken place among the banks, the government, and the general public about the so-called “transition costs.” Some Chinese bankers have suggested that it is the responsibility of the government to compensate the banks for accumulated losses caused by policy lending as well as lost profits due to policy restrictions on the scope of permitted banking business during China’s economic transition. In other words, in the view of the banks, the government should pay for the “transition costs.”

However, recent public opinion, and indeed the position of China’s banking regulators, has suggested that the banks’ argument is unsettling because it sought to make the central bank the virtual ultimate guarantor of all troubled financial institutions. If the “big four” suffered their losses primarily from policy restrictions and state intervention, other domestic financial institutions, such as the 112 city commercial banks and numerous rural credit cooperatives, will apply the same argument to ask for government bail-outs. This would be a catastrophic scenario as the moral hazard could spread across-the-board within China’s financial system.

Moreover, as to what constitutes real “transition costs,” it is not up to the banks to properly define it since they tend to distort the cause-and-effect account and disguise the losses from stealing, embezzlement, expropriation and failed speculation in the stock market under the cover of “transition costs.” In fact, from what has been revealed in previous discussion of the causes of NPLs in Section I, what constitutes the real “transition costs” seems to have some clear indications—the government, especially the local governments, which intervene in bank businesses, as well as bank staff who make blunders or cause losses in daily transactions due to incompetence, waste, and corruption, both have their shares in contributing to the NPL problem, thus both playing a role in the accumulation of the “transition costs.”

B. “Paying for a Modern Banking System”
The situation now is that the government is in a relatively weak bargaining position in negotiating reform measures with the banks while the general public, understandably, have little say in this interaction except expressing criticism in the media.

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50 Hu, supra note 38.
The banks now hold all cards to exploit the government’s concern about the danger of a systemic financial crisis caused by bank failures. In a sense, the moral hazard has led the banks to make a hostage of, or “hijack,” the government’s dilemma in fixing the financial system: it certainly cannot afford to let the banks collapse, but it also worries about the effect of money used. The result of this interaction, as judged from the current progress of banking reform, is that the government has been forced to take a position of “paying for a modern banking system,” as professed by some policy makers.

However, the problem here is that this philosophy of banking reform is a misnomer, and would be more accurately understood as ‘paying heftily for a uncertain prospect of a modern banking system,’ which implies a high risk of ultimate failure if it is not accompanied by a strategy of vigorous reform to turn around the corporate governance structure of the “big four.” Failing that, regardless of how much has been paid, and certainly will be paid again, a healthy banking sector in China is only an illusion.

IV. Shareholding Restructuring and Corporate Governance Reforms

After a series of measures to bolster the capital base of the state banks through both recapitalization and NPL transfer, the “big four” are now ready for shareholding restructuring, a necessary prior step toward launching overseas listings.

1. The Old Ownership and Management System for The “Big Four” and the New Changes

Formerly, the ownership and management system of the “big four” had suffered the same problem as China’s SOEs had before the State-owned Assets Supervision and Administration Commission (SASAC) was established: the split of ownership and control rights between separate government departments. In the case of the “big four,” until recently the Treasury had been the responsible agency to represent the state owner and oversee the banks’ incomes and expenses, while the CBRC had been in charge of personnel decisions as well as discipline and sanctions. To address the agency problem that this ownership and control structure has created, some Chinese economists have suggested establishing a “financial SASAC” to solely represent the state’s ownership rights in the “big four.” The reason why the SASAC itself is not suitable to play this role is that it would be a bad idea to have the same agency assume the ownership rights in both SOEs and their principal creditors, as it would certainly lead to conflicts of interest.  

Therefore, the shareholding restructuring that is underway at the BoC and CCB,

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the two banks that have been making most of the progress in the latest round of banking reform, would provide valuable lessons with regard to the reform of ownership and management systems in China’s banking sector. In this new effort of the government to experiment with ownership reform at the “big four,” the role of the Central Huijin Investment (Huijin), a newly created state holding investment company for the specific purpose of facilitating China’s financial reform, is important. Under joint supervision of the Ministry of Finance, the central bank and the State Administration of Foreign Exchange, Huijin was set up after the foreign exchange reserve injection into BoC and CCB in December 2003 to represent the state shareholder in these two banks. Huijin is wholly owned by the state and has a clear mandate to represent the state owner in exercising its rights and responsibilities in the “big four” and other major financial institutions.

Although Huijin itself is still a 100 percent state-owned company, its new role in the shareholding restructuring at BoC and CCB as their founding shareholder at least allows the state to remove itself from direct ownership of the banks. In the meantime, new board structures were also created at the two banks, including seats for both domestic and foreign independent directors. When the banks’ plan to introduce international strategic investors finally materializes, which will further diversify their ownership structures before overseas listings, there could be more meaningful results in banking reform. The latest development suggests that both BoC and CCB are in the process of soliciting large international financial institutions for their interest in buying minority stakes in the banks.

As complementary measures to their shareholding restructuring, the “big four” have also reduced the size of their staff and reshaped their employment, compensation and welfare systems to allow market forces to play a bigger role in their daily operation.

2. Shareholding Restructuring and Corporate Governance Reforms at BoC and CCB

A. BoC’s Shareholding Restructuring

On August 26 2004, the BoC announced that it had completed its shareholding restructuring. Huijin is currently the sole shareholder in the restructured BoC. The new BoC inherited all of its predecessor’s assets, liabilities and 188,700 staff. A board consisting of 11 directors, among them six from Huijin, was established and three supervisors were also appointed. In addition, Hong Kong’s former Securities and Futures Commission (SFC) chairman, Anthony Neoh, has been appointed the first independent director of the restructured BoC. According to the BoC, another foreign professional will also be invited to join the board some time later.52 The bank also announced that as it proceeds further to invite new strategic investors, more directors will be appointed. In July 2004, a list of potential strategic investors

52 Ibid.
was submitted to the State Council and Huijin for their review.\^3

\textbf{B. CCB's Shareholding Restructuring}

On September 15 2004, CCB announced its completion of shareholding restructuring. The former state-owned bank was split into a holding group and a shareholding company. The shareholding company serves as a listing vehicle for its planned overseas IPO. The holding group, named China Construction Bank Group Co. Ltd (CCB Group), took over the bank's non-banking businesses, valued at around 1 percent of its total assets. As part of its restructuring plan, CCB has set up China Jianyin Investment Ltd. (Jianyin) to hold its stake in the new shareholding company, along with four founding stakeholders, including Huijin and another three SOEs as domestic strategic investors.\^4

In the shareholding structure of the new CCB, Huijin holds 85 percent of the shares of the shareholding company. In addition, Huijin controls up to an additional 10 percent of shares through the holding group, which it owns exclusively. Therefore, Huijin in effect controls 95.88 percent of the shares in the new CCB. Previous proposals from economists for Huijin to put together a professional management committee did not interest government's policy makers. Instead, Huijin's management team will be staffed by officials from the government regulatory agencies, including the central bank, the State Administration of Foreign Exchange, and the Ministry of Finance.\^5 It has appointed six directors to the board of the new CCB shareholding company.

Despite the setback at Huijin of not establishing a professional management team, the corporate governance structure of the new CCB does seem to be an improvement in some respects. On September 21 2004, CCB appointed Masamoto Yashiro, chief executive of Japan's Shinsei Bank, as one of its two independent directors in a landmark step toward improved corporate governance.\^6 This move made CCB the first of the "big four" to recruit a foreigner as an independent director as it prepares for an overseas IPO. The appointment of Mr. Yashiro and another independent director, who is a professor at Tsinghua University, is a breakthrough in China's banking sector, where appointments have generally been determined by Party and government affiliations. Some financial analysts believe that this move will help improve CCB's profile and will be beneficial to the bank's overseas IPO.\^7

\^4 The remaining three major strategic investors in the new shareholding structure of CCB are all state-owned enterprises, including China Yangtze Power Co., Shanghai Baosteel Group, and State Power Grid Corp.
\^7 Owen Brown & Phelim Kyne, "Chinese Lender Blazes a Trail; Construction Bank Names CEO of
Meanwhile, CCB has also started selecting potential strategic investors. The US equity fund Newbridge Capital, which will soon take control of Shenzhen Development Bank, a well-performing Chinese shareholding bank, after clearance of government approval, and New York-based Ripplewood Holdings LLC, are among the candidates being considered.58

3. Establishing Internal Controls and Risk Management Systems

Since early 2004, the China Banking Regulatory Commission (CBRC), the principal regulator of China's commercial banks, has been pushing measures to strengthen banks' internal risk control and has devised an “interim method,” which was to take effect on February 1, 2005.59 As a follow-up, in January 2005 the CBRC again issued a set of Guidelines for Commercial Bank Market Risk Management as well as the Provisional Regulation on Assessment of Internal Controls of Commercial Banks. In these documents, the CBRC urged China’s commercial banks to improve their risk control and internal monitoring as China’s financial market opens to foreign competitors. The CBRC has indicated that it will tighten supervision over commercial banks where serious financial crimes have repeatedly occurred and pledged more inspections and punishment for wrongdoers. Meanwhile, because China’s banking industry is poorly prepared to handle the new types of risk that are expected to multiply as the financial system is liberalized, the CBRC also urged domestic banks to introduce risk control systems that would limit their exposure to financial market volatility.60

The promulgation of these regulations was largely spurred by the alarming fact that serious financial crimes happen too often in the banking industry because of lax internal controls. Corruption and embezzlement of funds at the “big four,” sometimes involving stunning amounts, have been reported extensively by both domestic and international financial media over the past few years. The most egregious bank scandals and corporate governance failures that have been recorded with the “big four” are discussed below in Section V. The most critical fact revealed by these cases is that China’s banking reform not only faces the daunting task of reducing NPLs, but also the challenge of curbing corruption through tightened internal controls and improved corporate governance. However, because the legal and institutional environments during China’s transition are still developing, these double tasks are not easy to achieve. This issue is revisited in the concluding Section VII, where the prospects for and necessary future steps in China’s banking reform are reviewed.

Japan’s Shinsei As an Independent Director” Asian Wall Street Journal (23 September 2004) A.3.

58 Yu, supra note 53.


V. Egregious Corporate Governance Failures at the "Big Four" and Their Repercussions

Drawing on international experience in measuring corruption and governance quality, such as the Corruption Perceptions Index (CPI) tracked by Transparency International, two Chinese economists have compiled an index of financial corruption in China (FCI). According to their estimates, for the year 2003 China’s overall FCI stood at 5.42 on a scale of 0–10, with 0 as the best and 10 as the worst level of corruption. The banking sector recorded a medium score of 4.17, compared to the staggering figure of 7.26 for the securities industry. These numbers are alarming, indicating the severity of financial corruption in both China’s banking and securities industries. The cases reported below regarding China’s banking sector are the most egregious ones and highly revealing of lax internal controls and other serious weaknesses in corporate governance of the “big four.”

1. The BoC Heilongjiang Sub-branch Missing Deposits Case (2005)

A recent embezzlement case at a BoC sub-branch in China’s northeast Heilongjiang province was revealed to the public in January 2005. This case involved missing deposits of more than RMB 1 billion (USD 121 million). The missing funds were suspected to be stolen by the former manager of the sub-branch, Gao Shan, who fled overseas just days before the case was brought to light. Investigators from the police and the BoC’s headquarters have launched a probe into the case, which has uncovered serious internal control problems at the bank. This was the latest in a series of scandals at the BoC in the past few years and is especially damaging when the bank is preparing for an overseas IPO. As a blow to investor confidence, Standard & Poor’s noted that “the incident underlines weaknesses in the bank’s relatively new internal control procedures.” This could delay the bank’s much-anticipated domestic and overseas listings, because investment bankers have commented that unless the BoC can show its risk control systems are capable of detecting problems in its sprawling branch network, investors will demand a discount on the offering price.

2. The ICBC Nanhai Branch Loan Frauds Case (2004)

In June 2004, China’s Auditor General released some shocking findings in its work report to the National People’s Congress, indicating that a local private entrepreneur

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62 Duan & Kang, supra note 57.
63 “Foreign Listings in New York: Big Apple Blues” The Economist (27 January 2005) 73 ["Big Apple Blues"].
in Nanhai city, Guangdong Province, Feng Mingchang, forged financial papers and conspired with bank executives to obtain fraudulent loans up to 7.4 billion yuan (USD 893.7 million) from the ICBC Nanhai branch. According to the audit report, a large portion of the loans was illegally transferred overseas. When the case was first revealed, it was reported that as much as 2 billion yuan (USD 233 million) had not been returned.65

In this episode, the delinquency on the part of the bank was outrageous: after being warned by risk-assessment officials from the upper branch that there were potential huge risks in lending to Feng, the Guangdong branch of the ICBC continued to lend billions to his company and its subsidiaries. Some bank officials have since been arrested on corruption charges. The scope of wrongdoing was stunning: when the case was finally brought to trial in January 2005, some 80 government officials and bankers involved had been either detained by the police or reprimanded by the Communist Party.66

According to the in-depth probe by China’s financial media, the real mastermind of this loan fraud was not Feng, but local officials in Nanhai city. They used Feng’s company as a front to divert most of the loans overseas, in order to offset gigantic losses the local government incurred in capital and real estate speculations in Hong Kong years ago. Many facts point toward local government officials’ manipulations behind the scenes.67 For example, bank records showed that Feng’s company and its affiliates obtained most of the loans by taking out mortgages on properties which they did not own or were grossly over-valued and the local land resource authorities provided Feng’s company with a string of fake certificates for these properties.68

Therefore, compared with the outright corruption commonly exposed by Chinese media, the Nanhai loan fraud scandal poses much greater risks. It reveals deep-rooted problems in China’s current political and economic systems during transition, calling for future reform measures to both combat corruption and clean up the banking sector.69

3. The BoC Shanghai and Hong Kong Branches Case (2004)

On February 20 2004, the BoC announced that it had removed Liu Jinbao as the bank’s vice chairman. Liu had been under investigation for suspected involvement in economic crimes since early 2002. In July 2004, government officials from the

68 Ibid.
69 Ibid.
Ministry of Supervision confirmed that Liu was suspected of embezzlement, bribery, and illegally approving loans. The alleged primary wrongdoing was Liu’s role as the head of BoC’s Hong Kong branch in its problem loans totaling HKD 2.1 billion (USD 270 million) to a Shanghai-based private entrepreneur, Zhou Zhengyi, in early 2002. However, the key factor in Liu’s downfall was widely believed to be not the Zhou Zhengyi case, but another series of problem loans extended by BoC’s Shanghai branch, when Liu was its general manager, to a local private enterprise group, Wantai. The Wantai case was exposed in December 2003, when financial inspectors from the Communist Party’s Central Committee discovered astonishing results in their probe into Liu’s wrongdoing: Wantai had taken 28 loans, worth 1.48 billion yuan (USD 178 million), from BoC’s Shanghai branch over four years. The total value of the loans plus interest was nearly RMB 1.6 billion yuan (USD 193 million). At the end of 2000, except for two loans that were not yet mature, 95 percent of these loans had become NPLs. What is more outrageous is that less than 25 percent of these NPLs were originally lent on collateral.

As the probe into the Liu Jinbao case went deeper, more scandals erupted at the BoC’s Hong Kong branch. In August 2004, the branch’s vice chairman, Ding Yansheng, was taken in custody by mainland police for his involvement in alleged misappropriation of funds. Ding was suspected of embezzling funds owned by controlling shareholders of former BoC member banks before the Hong Kong branch’s restructuring in 2001. Zhu Chi, another vice chairman of the branch, was later also under investigation for the same allegations. Specifically, Liu Jinbao was alleged of embezzling from the BoC’s Hong Kong branch HKD 4 million (USD 513,000), while Ding and Zhu each took HKD 1.5 million (USD 192,000). After misappropriating the money, they destroyed original bank records. The sequential departure of these three people left only one senior executive remaining on the board since the branch’s IPO on the Hong Kong Exchange in 2002. This scandal has spurred growing investor concern over the bank’s corporate governance and internal controls.

4. The former BoC President Corruption Case (2003)

In December 2003, Wang Xuebing, the former BoC president was sentenced to 12 years in prison for taking bribes worth RMB 1.15 million (USD 138,000) and numerous improper gifts. Moreover, Wang was alleged to have overruled subordinates at the BoC to make risky loans to favored clients and extend their credit terms during his tenure at the bank between 1991 and 1996. His case came to light just months after a loan scandal erupted at BoC’s New York branch. That scandal resulted in fines against the bank of USD 20 million by both U.S. and Chinese banking regulators. The details of this case are provided below.


In January 2003, an investigation by the US Office of Currency Comptroller (OCC) found BoC’s New York branch guilty of misconduct, for which it was fined USD 10 million. This incident was received by the Chinese government as a “welcome move” because the OCC’s action would encourage reform in China’s banking industry. Apart from the fines imposed by the US regulator, as the parent company of its New York branch, the BoC was also fined USD 10 million by China’s central bank for failing to maintain proper supervision and internal controls.

According to the investigators from the US Treasury, the offences of the BoC New York branch took place in 1991–1999, including improper loans to people who had personal relationships with bank officials and fraudulent loan and letter-of-credit schemes. These wrongdoings had resulted in a total loss of USD 34 million at this branch between 1992 and 2000. In fact, such abuses are believed to be widespread in China’s state banking industry, where influential borrowers receive special treatment and loans that are never repaid.

6. The BoC Kaiping Branch Embezzlement Case (2001)

Up to now, the largest case of spectacular embezzlement resulting from lax supervision and internal controls was the so-called “Kaiping Case” of 2001, which

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81 Hu & Gu, supra note 77.
involved bank funds worth at least USD 483 million being stolen between 1992 and 2001 by three managers at a BoC local branch in Kaiping city, Guangdong province. The three managers in question, Xu Chaofan, Yu Zhendong and Xu Guojun, had absconded overseas with embezzled money days before an investigation by BoC’s headquarters discovered this theft in October 2001.82 Yu Zhendong fled to the U.S. but was returned by the FBI to Chinese authorities in April 2004, while the other two still remain at large.83

This theft was described as the biggest banking scandal in China since the establishment of the communist government in 1949. Its scale was astonishing: the money stolen, USD 483 million, was more than the aggregate income of the city of Kaiping for the previous 10 years up to 2001, and the city had attracted just over USD 100 million in foreign investment by then.84

This case exposed how weak the internal controls were at the bank. The three former managers at BoC’s Kaiping branch were able to steal money from the bank for 8 years, and what is particularly appalling is that not only did the three go undetected but they were promoted during the time when the gross theft was taking place.85 More importantly, theft on a grand scale like this could not possibly have been committed by only the three people that have so far been identified as the chief culprits in the Kaiping case. Indeed, after Yu Zhendong was repatriated to the Chinese authorities by the US government, new evidence emerged as the investigation continued, suggesting possible involvements of others at the bank. The complete version of the real story has yet to be revealed as the case proceeds further.86

7. The Repercussions of Bank Failures and their Solutions

The enormity of these most egregious banking scandals in China is costing the country much-needed investor confidence at a time when the state banks are preparing for overseas listings. The negative impact of these bank failures is particularly acute when China’s transition has come to a critical point where the danger of an emerging “crony market economy” is looming large. In this context, banking reform, although primarily concerned with improving their corporate governance, especially with regard to the lax internal supervision and control, requires complementary measures to be adopted in related areas, most importantly anti-corruption and the transformation of the role of the government.

This need for complementary reform is clearly demonstrated in those reported cases, whereby senior bank officials taking bribes and colluding with private busi-
nesspeople to approve problem loans is a common situation. The power to control and allocate economic resources has been frequently abused for rent-seeking purposes. This cannot be cured only through corporate governance reforms at the banks without also changing the institutional and legal environments that incubate or indulge these abuses.

Moreover, from what has been revealed, local governments have often played a large part in some of the most serious bank failures, and not accidentally the province of Guangdong, China’s fastest growing regional economy, has contributed largely to the spectacular bank scandals of recent years. There are two main reasons for this peculiarity. First, because the role of the government, especially at local levels, is not yet properly defined to accommodate the needs of a market economy, government officials often interfere with banks’ lending decisions on behalf of their favored borrowers, which increases the likelihood of incurring NPLs. Second, because of the emphasis on one-dimensional “GDP growth” indicators to evaluate government officials’ performance, as has been maintained over the past decade by the central government, local officials tend to disregard the need for nurturing a healthy credit culture and establishing effective property rights protection mechanisms in their jurisdictions, which is certainly not helpful in averting loan defaults or financial fraud.

Another problem associated with these bank scandals is that China’s speculative stock market seems to have provided rent-seeking bankers with a strong incentive to illegally divert bank funds into the stock market for lucrative positive abnormal returns. This has had a negative impact on both the stock market and the banking sector, thus entailing the danger of threatening a systemic risk.87

Therefore, to effectively deal with bank failures and bring vigorous discipline and monitoring to the financial system, the following steps need to be taken at the next stage of China’s financial reform:

(1) Strengthening internal controls and corporate governance in the banking sector, and establishing personal accountability, including criminal liability, of bank officials who fail to perform their duty diligently or conduct corruptive activities that cause questionable loans or NPLs.

(2) Furthering liberalizing the financial sector and introducing competition to the state monopoly in credit provision and also share issuance, and bringing more market discipline into the financial system.

(3) Combating corruption in both the banking sector and the government to vigorously punish rent-seeking activities as well as outright fraud and theft.

(4) Implementing complementary measures to prevent the vicious interaction between illegally diverted bank funds and stock market speculation.

VI. The “Big Four” Preparing for Overseas Listings

After all necessary preliminary steps have been taken (their actual effect is another matter and will only be judged fairly after several years), the government is now preparing to sell minority stakes in the “big four” to international investors through their overseas listings. In this effort, BoC and CCB are making faster progress than ICBC and ABC and their planned IPOs are expected to take place as early as in the second half of 2005.

1. The Reasons for Overseas Listings

As widely recognized, the most important reason for overseas listings is that forcing China’s state banks to subject themselves to a much higher level of scrutiny by international market regulators, even at the cost of embarrassing exposures of scandals, may be an effective inducement to bring about systemic changes in the whole banking sector. The requirements of transparency, managerial performance and investor returns in overseas capital markets would be beneficial disciplines on China’s banks and would compel them to meet the challenge from international competitors as China further liberalizes its financial sector.

According to expert opinions, the government’s main goal in banks’ overseas listings is not to raise cash. Compared to how much money the government has so far used to bail out the indebted “big four,” which has reached a total of USD 250 billion in recent years, proceeds of overseas listings, not exceeding USD 10 billion for each bank, would be modest. Therefore, instead of more funds, the government hopes to introduce vigorous discipline and monitoring of banks’ lending practices that must accompany China’s transition to a market economy. For example, fixing lax lending standards that comes with inspection by international auditors and management consultants is critical if the “big four” are to compete effectively against foreign competitors when China’s banking sector opens fully in December 2006.

2. The Shadow Surrounding the Listing Plans of BoC and CCB

The most relevant issue is the choice of listing location where the “big four” will launch their IPOs. The coming into force of the Sarbanes-Oxley Act (SOX) has given China’s banks second thoughts. Tightening securities market rules and ongoing investor litigation against listed companies, such as the class action brought by American investors against the insurer China Life, are deterring BoC and CCB from listing in the US.

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88 CCB expects to raise USD 5 billion – 10 billion in its IPO, while the BoC is hoping for USD 3 billion – 4 billion from its own flotation.
89 “Casino Capital”, supra note 4.
90 Bei Hu & Bloomberg, “Theft May Postpone BOC’s Planned Flotation” South China Morning Post
Recently, the BoC, which is expecting an overseas listing as early as in the second half of 2005, announced that although it has not yet decided where its shares will be listed, SOX will be a strong influencing factor in its final decision. It is widely believed that the stock exchanges in Hong Kong and London are very likely to be the final listing places for a dual IPO of the BoC. As to CCB, uncertainty still surrounds its final listing plan. It has been indicated by the bank that the stock exchanges in Hong Kong or Singapore will be the primary market of choice, supplemented by a 144A private placement in the US, which does not require filing financial statements with the SEC, and POWL (public offers without listings) in Japan. CCB is also studying possibilities of listing in China’s A-share market.

Some western commentators have frowned on the uncertainty in the banks’ listing plans, arguing that if the BoC and CCB do opt out the NYSE because of its stricter regulation standards, this might send a bad signal to potential investors, which is not desirable at a time when the two banks are already struggling to persuade foreign banks to take minority stakes.

There are other difficult issues as well. For example, because some potential investors in CCB and BoC are worried about the health of their balance sheets and question whether the banks’ lending practices have improved enough to avoid a sharp rise in NPLs after their IPOs, they are pressuring the Chinese government to pledge help to the two banks as a condition for their overseas listings. International investors believe that a promise of financial support by the Chinese government is essential to mitigate fund managers’ concerns about the first international IPO from China’s banking system. They demand that the Chinese government make an open pledge to international investors because the market will not trust what the banks state in their prospectuses.

However, this demand for a government pledge from the international investors is not likely to be accepted by the Chinese government. As just explained, the very reason of listing the state banks overseas is to introduce vigorous discipline and monitoring by both regulators and investors in mature capital markets, thus establishing effective corporate governance mechanisms to avoid further accumulation of NPLs. Therefore, an open pledge by the Chinese government that it will bail out the banks in times of financial debacles would actually work against the government’s expectation of the banks’ overseas listing— the removal of moral hazard from the “big four” and the instalment of market discipline into their daily

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91 Rule 144A is a safe harbor exemption from the registration requirements of Section 5 of the 1933 Securities Act in the US for sales of certain restricted securities to qualified institutional buyers, which are commonly referred to as QIBs. A POWL is a share issuance structure that enables firms to offer stock to retail investors without listing on the local exchange.

92 Yu, supra note 53.

93 “Big Apple Blues”, supra note 61.

94 Francesco Guerrera, “Call for Beijing to Pledge CCB Aid” Financial Times (17 September 2004)
operation. Otherwise, the NPL problem will not diminish even after the banks go public on the overseas capital markets.

Despite these negative reactions to the listings of Chinese state banks from the international capital markets, what will really happen to the IPOs of CCB and BoC, and eventually the other two of the “big four,” ICBC and Agricultural Bank of China, still remains to be seen. After all, as the banks are preparing for their overseas listings, the fact that China's banking reform has proceeded this far is already a significant step toward ultimately establishing a modern banking sector in China. Although this process will certainly take time, it is encouraging that the Chinese government started to make significant policy changes in the banking reform strategy addressing both ownership restructuring and corporate governance improvement.

VII. Conclusion

According to recent progress reports of major international rating agencies such as Moody's and S&P, China's banking system is “in the midst of revolutionary change” and the outlook on China's banking system is “positive.” Even with these optimistic estimates, China's banking reform is by no means an easy task and is expected to be a gradual and highly challenging process in order to establish a modern banking sector operating on the basis of commercial lending and prudent credit scoring. Predictably, more resources and political determination are needed to push further the banking reform. This is an overall assessment of the prospects of China's banking reform.

With respect to necessary future steps of reform, the following remarks are intended to provide some indications of reform direction and policy recommendations.

1. There are Two Key Issues in China's Banking Reform, Both of Which are Closely Associated with Reforming the Legal and Institutional Environments

There are two key issues involved in China's banking reform: addressing the NPL problem, and reforming the ownership structure of state banks and the poor corporate governance it produces. As earlier discussion suggests, the NPL problem is only partly attributable to state intervention, and a large portion of NPL creation has its causes in other aspects of China’s transition economy that have been lagging behind market-oriented reforms. These other aspects are primarily related to legal and institutional underdevelopment during China’s transition, such as the lack of effective bankruptcy rules to recover lenders’ claims, the weaknesses in

local credit culture to honour loan repayments, and the single-dimensional role of local governments in promoting regional growth that has led to imprudent loan allocation. Therefore, in addition to reducing state intervention, the ultimate solution to the NPL problem would also require further progress being made in reforming China's legal and institutional environments.

Similarly, reforming the ownership structure of the state banks, while necessary, if without advances in transforming the role of the government to suit a market economy, a state owner with a controlling stake in shareholding banks would not essentially change its pattern of behaviour, leaving the removal of government intervention in banks’ lending decisions an impossible task.

2. Devising Mechanisms to Contain Rent-seeking Activities is both a Critical Complement to Banks’ Corporate Governance Reforms aimed at Strengthening Internal Controls, and a Necessary Condition for Market Mechanisms to Develop in a Benign Environment

During China’s transition, market-oriented reforms have come to a critical point where signs of administrative power entering into the market for rent-seeking opportunities are emerging. In this sense, the danger of China moving toward a “bad market economy” is not an imaginary threat. In China’s current institutional environment, where market mechanisms are being developed under a largely illiberal political regime, those with control over resource allocation, such as bank officials in charge of allocating scarce capital, have a natural tendency to enter the rent-seeking process. This is among the primary causes for corporate governance failures at the state banks. Accordingly, devising mechanisms to contain rent-seeking activities, which in turn would lead to legal reform and government transformation, is a crucial complement to banks’ corporate governance reforms aimed at strengthening internal controls. In the meantime, the development of market mechanisms also needs to be free from the distortion brought by rent-seekers. In this connection, China’s banking reform must proceed with the assistance of anti-corruption campaigns in the financial sector.96

96 For example, in March 2005, the former chairman of CCB, Zhang Enzhao, abruptly resigned from the bank for “personal reasons,” and has been under investigation by the anti-corruption department of the Communist Party. The real reason behind his departure from the bank, as widely speculated in China’s financial industry, is not likely to be “personal” but possibly relates to a lawsuit filed in the United States, alleging that Zhang took a bribe of USD 1 million from an American firm for helping it to secure a lucrative information-technology contract with the bank. The plaintiff in this case is a former business partner of CCB, Beijing-based Grace & Digital Information Technology, which claimed that it was deprived of business benefits under its previous contract with CCB. The principal defendant is Fidelity Information Services, an American financial services company, which was accused of bribing Zhang to sign a new contract that excluded the plaintiff. Accordingly, Fidelity Information Services is faced with the allegation that it violated America’s Foreign Corrupt Practices Act, which prohibits American firms to bribe government officials in foreign countries in exchange for business opportunities. See “Personal Banking” The Economist (23 March 2005). This latest bank scandal has spurred a new round of intense debates among
China's banking reform, while closely associated with the SOE reform, is distinct from the latter in terms of viable ownership reform options. The shareholding restructuring and planned overseas listings of the "big four" are positive and necessary steps toward establishing a modern banking system in China, but further privatization would be extremely difficult for both economic and political reasons.

Under any potential privatization scheme for the "big four," who would be eligible for taking a controlling stake is a highly sensitive issue in a political sense, given the critical role of the banking system in China's economic structure. Economically, since the "big four" are all of gigantic size and in combination control 60 percent of China's total bank assets, to obtain a controlling stake would require capital investment worth up to 50 percent of China's GDP. This is in practice extremely difficult for any private or foreign equity investors to finance. Besides, foreign controlling stakes at the "big four" would result in billions of dollars pouring into China, thus putting the country's domestic monetary stability at tremendous risk and engendering an inflation crisis.

Therefore, unlike China's SOEs, the "big four" are not suitable for privatization, at least at the current stage of banking reform. By comparison, a more viable option is to invite domestic and international strategic investors to hold minority stakes, which would be both politically realistic and commercially viable. Besides, overseas listings and even moderate reform of the ownership structure of the "big four" is likely to generate considerable corporate governance improvement, because disciplines in global equity markets can mitigate the agency problem much more effectively than could the domestic stock market, which is speculative and retail-oriented.

Further opening up China's financial system under its WTO commitments will in general have a positive effect on its banking reform. As foreign and private competitors challenge the monopoly status of the state banks in providing financial services to the Chinese public, heavier pressure from the market could be imposed on the "big four" to perform and increase their operational efficiency and quality

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both domestic and overseas commentators, over whether Chinese state banks are yet "ready" to go public overseas before "cleaning house" at home first.

5. The Complementary Nature of Structural Reforms is a Central Theme of China’s Transition

The strong complementarity between structural reforms of China’s banking system, SOEs, and stock market is not only implicated in the long existing lender-debtor relationship between the banks and SOEs, which has not been based on commercial terms for years, but is also evidenced by the risky pattern of bank funds illegally entering the stock market for lucrative returns on share speculation, which creates more bubbles and increases the possibility of a systemic financial crisis. Therefore, China’s banking reform cannot afford to be delayed further and must proceed decisively as an urgent priority. Failing that, the prospects of the privatization of SOEs and stock market reform could be severely compromised.

6. The Proper Sequencing of Banking Reform is that “Cleaning House” and Overseas Listings should Proceed Simultaneously to Create Synergies of Complementary Reform Initiatives

The specific issue of sequencing involved in the process of China’s banking reform is highlighted in the ongoing debate in China’s policy and academic circles over the appropriate approach toward reforming the “big four” state-owned commercial banks plagued by both NPLs and rampant corruption.

On the one hand, some Chinese economists and foreign commentators argue that China’s banking reform should adopt an approach of “cleaning house first, going public overseas second,” which prioritizes corporate governance reform to strengthen internal controls and curb financial corruption over overseas listings. On the other hand, other economists advocate an alternative strategy, which sees overseas listings as an external lever to propel corporate governance reform and greater competition in the banking sector. The latter position on the sequencing of banking reform presents a rationale for accelerated financial reforms at later stages of China’s transition, which is similar to China’s primary motivation in joining the WTO in 2001, that is, to obtain an external lever to precipitate deeper and broader structural reforms when domestic conditions, especially the political will, have not been fully receptive to such advances.

In light of this controversy over the sequencing of China’s banking reform, the basic judgment of this study is more in line with the latter position, that is, pursuing overseas listings as a strategy for achieving external stimuli for otherwise reluctant or difficult reforms under existing political and institutional constraints. While it is uncertain how long and how much resources it will take to achieve meaningful results in domestic corporate governance reform and anti-corruption initiatives in China’s banking sector (that is, “cleaning house”), the urgency of preparing China’s banks for greater competition from overseas financial institutions under the country’s WTO commitments is clear. More critically, the complementary role
of banking reform in helping achieve positive results in China’s enterprise and stock market reforms provides an even stronger rationale for seeking overseas listings even if the banks are not yet independent commercial lenders and efficient resource allocators. It is widely held by many Chinese economists that external pressures from international investors and regulators could propel or force fundamental banking reforms at home, which might otherwise be off the government’s reform agenda because these reforms will be painful and unavoidably bring about large dislocations in the national economy.

Meanwhile, although overseas listings are necessary for creating incentives to perform and compete in China’s banking sector, they are not sufficient to bring about good corporate governance, effective internal controls, and significant reduction of corruption. Rather, domestic reform initiatives to build good legal, financial and corporate governance institutions should go hand in hand with overseas listings to best utilize and capitalize on the benefits of good institutions and of the much tighter discipline provided by overseas markets.