Thornhill Capital

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China's Banking System

China's banks play a significant role in both the Chinese economy and in their economic policy. In fact, commercial banks are the dominant force in China's financial system, even to the extent of determining pricing. The key characteristic of China's banking system is what has been referred to by Carmen M. Reinhart, Jacob F. Kirkegaard, and M. Belen Sbrancia as financial repression.[3]

Financial repression occurs when governments implement policies to channel to themselves funds that, in a deregulated market environment, would go elsewhere. Policies include directed lending to the government by captive domestic audiences (such as pension funds or domestic banks), explicit or implicit caps on interest rates, regulation of cross-border capital movements, and (generally) a tighter connection between government and banks, either explicitly through public ownership of some of the banks or through heavy "moral suasion."

Financial repression is also sometimes associated with relatively high reserve requirements (or liquidity requirements), securities transaction taxes, prohibition of gold purchases, or the placement of significant amounts of government debt that is nonmarketable.

Financial repression issues come under the broad umbrella of the government efforts to ensure the health of an entire financial system. [3]

Four banks in China account for 60% of the $15 trillion dollars in financial assets held by state-controlled commercial banks: the Bank of China (BOC), China Construction Bank (CCB), Agricultural Bank of China (ABC), and China's largest bank, Industrial and Commercial Bank of China (ICBC). These four banks hold 58% of all household deposits and 50% of all corporate deposits. Moreover, according to Carl Walter and Fraser Howie, who have extensively studied the Chinese banking system, Chinese banks are the major force behind all capital raising in China. For example, in 2007, prior to the global financial crisis, Chinese equity financing raised $123 billion in funds. At the same time bank loans totaled $530 billion, and debt issued in the bond market comprised another $355 billion. In China, banks underwrite and hold more than 70% of all fixed income debt. In China the banks are everything, and the government knows it. [1]

At the same time foreign banks constitute less than 2% of the total domestic financial assets, and that number is likely to decrease as foreign banks have been liquidating much of their China investments. The Bank of America, which in 2005 signed a $3 billion pact to acquire 9% of China Construction Bank, viewed their investment as a way for them to obtain access to tens of millions of Chinese investors. They were not alone. Between 2004 and 2009 foreign banks invested more than $33 billion into Chinese banks. However, more recently, the Bank of America has since sold down its holding to about 1% with the Goldman Sachs Group and HSBC Holdings also seeking to unwind their investments.

One reason for the recent unwinding of foreign investment in domestic Chinese banks are the more stringent capital rules, including Basel III, the global regulatory standard on bank capital adequacy being introduced in 2013, that makes a minority stake less attractive. As the Wall Street Journal explains, if the sum of a bank's minority investments in other financial institutions exceeds 10% of its core capital, then the amount in excess of that threshold must be deducted from its own capital. Also, if the bank owns more than 10% of another financial institution, then up to 100% of the investment could be deducted from

its core capital. [12]

However, investments in Chinese banks and financial service companies have proved to be very profitable as the Bank of America did make a handsome profit on their investment in China Construction Bank, and HSBC's stake in Chinese insurance company Ping An did increase by over 600% in the ten years they held their stake in the company. Indeed, many foreign banks, as a pure investment, have held on to their stake in Chinese banks. HSBC, for example, continues to hold a 19% stake in the Bank of Communications, China's fifth largest bank by assets. Spain's CaixaBank owns 16.1% of Hong Kong's Bank of East Asia Ltd., Deutsche Bank owns 19.99% of Hua Xia Bank Co., a midsize Chinese lender, and BNP Paribas owns 14.7% of the Bank of Nanjing. [12]

However, in spite of these profits, banks are likely, over time to sell much of their stakes in Chinese banks, especially with Basel III beginning January 1st. Banks have found that selling minority shares improves their capital ratios, especially since many feel that their investment may not have the growth that they experienced in the past. In addition, the original reason they bought minority stakes in a Chinese bank, to get access to a large number of Chinese banking customers, never materialized. For these reasons foreign ownership in Chinese banks are likely to decrease. [12]

Chinese banks have gone through a significant transformation over the years. After the Chinese revolution in 1949, the Chinese sought to create a central banking system. Since contact with countries outside of China was very limited at the time, Mao Zedong sought the assistance of Soviet advisors. However, progress was slow and, in 1957, Mao tired of the Soviet advisors and sent them home. The following year Mao began The Great Leap Forward, a program that was designed to transform China from an agrarian society to one that was more industrialized and collectivized. Private farming was prohibited and collectivized as Mao sought to finance China's industrialization by taking control of agriculture, thus allowing the state to buy at a low price and sell at a high price. However, collectivization resulted in chaos and China's food supply was drastically reduced, resulting in a famine that caused the death of millions. Mao resigned as State Chairman in 1959 and Deng Xiaoping took effective control of the economy.

In 1966, Mao initiated the Cultural Revolution, a program to weed out counter-revolutionary elements in Chinese society, and threw the country into chaos until his death in 1976. With the country in turmoil, focusing on the country's banking system was not a priority. [1, 8]

China's modern banking system really began in 1976 at the close of the Cultural Revolution. At that time there were no functional banks in China. Banks during this time, instead, were based on the banking model of China's closest ally, the Soviet Union, and were controlled by provincial Party committees. China was, for all intents and purpose, bankrupt. There was no national economy and only a collection of fiefdoms, held together by the Chinese Communist Party (CCP), existed.

Gradually, as a result of Deng Xiaoping's Open Door Policy, China became more open to foreign influence, but progress in making changes to the nation's banking system remained slow. Uncontrolled lending and corruption was prevalent with inflation rising to nearly 20%. In 1988, for example, there were 20 banking institutions, 745 trusts and investment companies, 34 securities companies, 180 pawn shops, and an unknown number of finance companies spread throughout China. In addition, each level of government established their own financial entities with a poorly trained staff and little direction. Senior appointments were controlled by the CCP and were largely political. The country had no singular banking decision maker or focus. Instead, each level of government, to some extent, had their hand in setting financial policy.

It wasn't until 1990 that China abandoned the Soviet model and instituted a model largely based on the United States. New bank laws, accounting regulations, and an independent central bank brought about rapid changes to the country's financial institutions. America was viewed as the epitome of financial wisdom at that time, and its banking practices were widely employed within China. All that changed in 2008 with the global financial crisis. The American model lost all credibility within China and banks went on an extensive lending binge. In 2009 and 2010 alone China's banks lent more than 20 trillion RMB. [1]

Today, China's banking system is administratively controlled by the People's Bank of China (PBOC), not to be confused with the Bank of China (BOC). The PBOC is China's

central bank which regulates financial institutions and controls monetary policy. It was established in 1948 and, between 1949 and 1978, was responsible for both central and commercial banking. In 1979 the government broke up this "all-in-one" banking system into what they term "specialized" banks. The commercial banking functions of the PBOC were split off into four independent state-owned banks. The first to be split off was the Agricultural Bank of China to provide for rural financing. The second was the Bank of China to provide foreign trade payments, settlements, trade financing, and shipping insurance. The next bank to be split off from the PBOC was People's Construction Bank of China, later renamed China Construction Bank. This specialized in large-scale infrastructure financing. The last bank to be split off was the Industrial and Commercial Bank of China in 1983. This bank took over from the PBOC all industrial and commercial banking operations and services, including the savings business. It subsequently became China's largest bank. Therefore, in 1984 China had a central bank and four specialized banks. They created, at long last, stability in China's banking system.

Subsequently, in 1989, growth within China had progressed to such a point that every province wanted to develop itself immediately. To do that, they needed money. Moreover, the government was having difficulty controlling the provinces and inflation and food prices soared. It was at this point that the central government stepped in to try and bring inflation under control and realized that the specialized banks were not real commercial banks, as they operated at the direction of the CCP. Therefore, in 1994, the government created three policy banks. The first policy bank to be formed was the State Development Bank, now called the China Development Bank (CDB). The second was the Export-Import Bank of China (Eximbank). The third was the Agricultural Development Bank of China (ADBC). These banks were hugely attractive to the Chinese banking system as the government transferred to these banks government-dictated loans, thereby allowing the specialized banks to focus on commercial loans. [10]

In 1998 the PBOC underwent further modernization with the abolishment of its local and provincial branches, opening nine regional branches instead, and strengthening its role in the making and implementing monetary policy. Regional branches were now designed to serve several provinces.

As a result, this new structure put to an end the ability of provincial banks to be unduly influenced by government officials into making loans that would otherwise not have been made. [5, 6, 7, 10, 11]

In addition, in continuing its overhaul of the banking system, the Ministry of Finance injected $32.5 billion into the four commercial banks to augment their capital. Today, the PBOC is the largest central bank in the world with $3.201 trillion USD. However, the government still knew it had a problem with bad loans. The only question was, what to do about it. After much internal debate, the central government decided to carve off $169 billion in non-performing loans from the country's four commercial banks and place them into asset management companies (AMC), somewhat similar to the Resolution Trust Company, a U.S. government owned asset management company that was charged with liquidating the assets of savings and loans. [5, 6, 7, 10, 11]

Unlike the U.S. Federal Reserve, the PBOC cannot make decisions regarding monetary policy without the concurrence of the CCP. Any announcements it does make would have to integrate into the government's plan of maintaining social stability. [5] The PBOC is overseen by the China Banking Regulatory Commission (CBRC). In China, all decisions emanate from the government and there's no independent decision making body capable of instituting policy without the concurrence of the CCP. The CCP decided how they wanted the banking system within China to work, and that system is reflected in the country's current banking model.

Also, the Chinese banking system is thinly capitalized with a ratio of equity to assets of 6%. In addition, according to The Economist, there are two primary concerns regarding China's banking system. The first is the possibility of bad local-government debt. The second is bad property loans.

In the aftermath of the world financial crisis, China initiated an infrastructure boom in local government financing, and off-balance sheet entities, to get around prohibitions on borrowing. Local government debt is thought to be worth approximately $1.4 trillion, with 20% - 30% of that debt non-performing. In trying to control this vast amount of bad government debt, the national government has directed banks to roll over these loans and issue local bonds in its

place. [4]

However, problems remain within China's banking system. These problems include: [9, 10, 11]

Bad loans to State Owned Enterprises (SOEs): SOEs weren't originally created to be money-making machines. Instead, they were designed to employ large numbers of people and create the basis of social stability. Everyone would have a job. Therefore, loans to SOEs are often based on political, rather than commercial criteria. In fact, the amount of loans to SOEs is so massive that it constitutes 90% of all Chinese banking loans. Chinese banks, therefore, are quite often a funding agent for directed government subsidies to SOEs, rather than acting in the capacity of a prudent lender. In addition, SOE's will very often use loans from the bank and invest the money outside the company. For example, it's common for an SOE to obtain a loan from the bank and then re-lend the money out to smaller companies who don't qualify for bank loans, and at a much higher interest rate. The SOE thereby makes an interest rate spread on the borrowed capital and improves its bottom line. One of the problems with this scenario is that SOEs borrow so much money from China's banking system that there's simply not enough capital to loan to all companies who require a loan. Instead, these companies are often forced to borrow money from SOE's, shadow bankers, or peer-to-peer lenders at a significantly higher cost than a traditional bank loan. As a result, many of these smaller companies have gone out of business as their cost of capital makes it difficult for them to succeed.

Loans to property developers: Loans continue to be made to property developers in spite of the government's efforts to minimize loans in this sector. When this happens, developers who obtained bank funding so that they could start their project have traditionally obtained capital from the pre-sale of units, and they then use this money as collateral to obtain additional real estate loans. But, as the economy changes, so does the demand for real estate. Some developers and bank loan officers soon discovered that a pull-back in the economy, coupled with the implementation of more stringent government laws, which set limits on the purchase of a second or subsequent property, resulted in many developers going bankrupt. When a project was started without all funds being in place, developers often had to

abandon construction for a lack of funds to complete the project. Therefore, during this period there was a large increase in the number of unfinished buildings.

Corruption: Corruption remains a problem, with one bank alone reporting the issuance of 4,700 bogus mortgages worth over $169 million and another reporting 3,700 bogus mortgages worth over $95 million.

Theft: Theft is a major problem. In an example given by Harold Chee and Chris West, a Chinese JV partner took out a loan with a Chinese bank as a gesture of goodwill to the Chinese government. The company intended to repay the loan over a number of years and the bank assigned someone to specifically handle this account. Eighteen months later the bank said that the loan manager had died and that there was no record of the company ever making their monthly repayments. Apparently, the company concluded, the bank employee had taken the repayments. The "dead" employee was later seen by one of the company's employees shopping in a local mall.

Bad Debts: It's estimated that 30% of the loans made by Chinese banks, or approximately $150 billion, is bad. However, some estimate that this figure is too low and the real number could be as high as $500 billion. Canadian banks, as a comparison, average about a 2% non-performing loan ratio.

When China became a member of the World Trade Organization (WTO), it agreed to open its financial markets to foreign competition by 2007. In anticipation of the opening of these markets to foreigners, many foreign banks invested heavily in expanding their networks within China, focusing largely on China's huge domestic consumer market. However, foreign banks have not received their anticipated level of government support. Rather, they now receive less government support post the 2008 financial crisis as the CCP now views foreign financial models as non-responsive. In addition, the government has no intention of fully allowing foreign bank access to their domestic population. Foreign banks are in China to make money. Domestic banks serve the government and the CCP. In addition, they will take direction on the placement of bank loans so that the government can better control the economy, inflation, and domestic tranquility. [1, 2]

The Chinese government knows that the stability of their banking system is directly related to the country's financial and social stability and their remaining in power. For all their wealth, Chinese banks are not as aggressive into international expansion as one would think. One reason is that they simply don't operate as traditional banks. Instead, they are largely controlled by the government who want to focus the banks resource internally to enhance domestic stability. In addition, the repayment of loans takes on a wholly different meaning for a Chinese bank as many loans are made at the direction of the government and, if these loans go un-repaid, then the banks are not called to task because of the bad loans. Lastly, bad loans are not always revealed publicly by Chinese banks. The fact that many problems with non-performing loans go unreported causes balance sheets to look stronger than they actually are. The government, for its part, hopes that its continued economic growth will go a long way in solving its banking problems and that these problems will fade away with a growing economy. At its current 8% rate of growth, it very well could.[1, 9]

Newsletters and blogs on China can be obtained by visiting Thornhill Capital's web site's at www.thornhillcapital.net and http://thornhillcapital.info/ or by e-mailing us at info@thornhillcapital.net

Endnotes:

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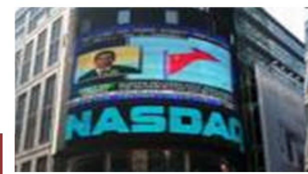

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