Risk Management in China's State Banks – International Best Practice and the Political Economy of Regulation

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1. Introduction

Banking reform has a top priority on the political agenda of the Chinese central government for more than ten years. The law on commercial banks enacted in 1993 aimed at transforming the country’s four state owned commercial banks (SOCBs) into independent business entities that are responsible for their own profits and losses. In the face of the Asian crisis in 1997/98 the central government decided on a partial recapitalization of the SOCBs in order to put them on a solid basis and accelerate the process of commercialization. In 2003 the administration under Hu Jintao opted for a more comprehensive reform package including a second wave of recapitalization, the partial privatization of state banks, intensified competition and strengthened banking regulation and supervision. The induced institutional changes address most of the factors that have been crucial for banking reform in the fast track transition countries in Eastern Europe (Bonin and Wachtel 2005). Barth et al. (2004), therefore, argue that the Chinese central government demonstrates a credible commitment to banking reform suggesting that non-performing loan (NPL) ratios eventually will decrease to manageable levels. Recent empirical assessments of China’s banking reform, however, find no clear evidence that SOCBs have changed their lending behaviour and become more commercially oriented (Podpiera 2006, Garcia-Herrero et al. 2006).

The persistence of lending patterns despite comprehensive restructuring can be explained by the strategies of relevant actors to capture reform measures for their own ends. Reforms and structural change are embedded in a country’s specific institutional context and unfold their own dynamics and interdependencies. The “normative analysis as a positive theory” argues that regulation appears in the face of market failure and therefore serves the public interest (Joskow and Noll 1981). Accordingly, the main-stream of economic literature argues that banks need to be supervised because systemic risks arise when the failure of a (potentially) insolvent bank also causes depositors of other banks to withdraw their money and triggers panics and bank runs (Dimond and Dybvig 1983; Postlevaite and Vives 1987; Chari and Jagannathan 1988). A main concern of banking reform therefore is the implementation of effective means for the measurement of default risks and the enforcement of appropriate loan-loss provisioning. But financial institutes have also been subject to regulation in many countries and for many centuries because government officials wish to use banks for their own ends (Benston and Kaufman 1996). As a result banking regulation for the sake of financial stability may be compromised by the aim of politicians to deploy banks, either to extract rents or to enforce power-preserving measures.

In fact the Chinese government has a pivotal role in capital allocation. Credit decisions are not only a matter of economic reasoning but also a means to
enforce initiatives of the political leadership. The SOCBs fulfil crucial functions for the economic development strategies initiated on the central as well as on the local level. Hence banking regulation and bank reform have large distributional consequences and are subject to political bargaining and resistance (Shih 2004). In recent years, banking regulation in China became increasingly influenced by the formulation of global standards such as the two Basel Capital Accords (Basel I/II) and agreements on international trade in financial services within the contract framework under the WTO. International best practices deprive politicians, to a certain extent, from their discretion to shape national regulations. Regulatory capture within the banking sector, therefore, has been shifting from the law making process to the issue of enforcement (Brehm 2007).

Assessing management practices against the background of a gap between formal rules and respective modes of implementation has methodological implications since publicly disclosed data reflect such systemic deficiencies only to a limited extent. In this context, an institutional analysis of the relation between politics and economic adjustments can provide an effective prognostic tool because it takes into account that political action depends on a government’s ability in building ownership of reforms among stakeholders. This article, therefore, provides a closer look on incentive mechanisms that shape enforcement of sound risk management practices in China’s state banks. The claim is that the design of banking regulation in China does not account for regulatory capture through incentive compatible institutions. None of the relevant actors involved in banking reform and internal restructuring of SOCBs have a strong interest to press for improved risk management in the short and medium run. Financial stability, therefore, remains a major concern despite a comprehensive approach to banking reform that is in line with economic wisdom and respective recommendations of international bodies such as the IMF, the World Bank or the Basel Committee for Banking Regulation and Supervision.

The remainder of this paper is organized as follows. Section 2 outlines the changing principles of banking regulation in China, sections 3-5 discuss incentives for improved risk management through supervision, corporate governance, and markets, and section 6 outlines the impact of banking regulation on risk management practices. Section 7 provides a conclusion.

2. Changing Principles for Banking Regulation

Banking regulation is broadly divided into two distinct concepts – economic regulation and prudential regulation (Mayer 2004). The former embraces measures such as interest rate ceilings, capital controls, barriers to market entry or state-guided lending and can be employed to mitigate market failures in the allocation of resources. Gerschenkron (1962) states, that
government intervention into loaning decisions of banks might be necessary in developing countries since immature financial markets do not provide sufficient capital to build up an industry and facilitate technical modernization. Therefore the state has to extend its actions beyond the institutional framing of markets and actively promote fund-raising and capital allocation. But economic banking regulation bears a risk of capture since it is also a key to political power. Skocpol emphasizes, “a state’s means of raising and deploying financial resources tell us more than could any other single factor about its existing (and its immediately potential) capacities to create or strengthen state organizations, to employ personnel, to co-opt political support, to subsidize economic enterprises and to fund social programs” (Skocpol 1986:17). As a result banking regulation for the sake of financial stability may be compromised with the aim of politicians to deploy banks for their own ends.

The problems arising from the political capture of state banks became evident during and after the Asian financial crises in 1997/98. The widely praised Asian capitalist model of close cooperation between state bureaucracy and economic actors turned out to embrace unanticipated threats for financial stability since it was prone to cronyism and bad management. Banks had adverse incentives to take excessive risks with borrowed money because outsiders, such as regulators and creditors, were unable to monitor and control the management and lending strategies they pursued (Brownbridge and Kirkpatrick 1999). These insights, together with a global trend to financial market liberalization, increasingly repelled economic banking regulation in favour of a second category – prudential regulation. Its main goal is to maintain financial stability and focuses on risk provisioning and disclosure. Prudential regulation, as the IMF and the Basel Committee for Banking Regulation and Supervision promote it, is based on rules and enforced by politically independent agencies. In recent years most of the Asian developmental states (under pressure from the IMF) dismantled economic regulation, adopted prudential rules and strengthened enforcement.

Also China began to emphasis prudential regulation as a new approach to govern its banks. In 2003 the Law on Banking Regulation and Supervision\(^1\) (LoBRS) strengthened the supervisory function in the PRC and transferred competences from the People’s Bank of China (PBC) to the China Banking Regulatory Commission (CBRC). Supervisory responsibilities are now shared between both agencies. The PBC is responsible for maintaining macroeconomic financial stability. It therefore monitors and assesses the situation of the financial

\(^1\) The provisions of the LoBRS are applicable to the supervision of banking institutions, asset management companies, trust and investment companies, finance companies, financial leasing companies and other financial institutions established in the PRC. Furthermore, the CBRC supervises financial institutions, which, being subject to its approval, are established outside the PRC as well as overseas businesses of national institutions (Art. 2 LoBRS).
market (Art. 30 LoPBC), supervises banking institutions, other groups and individuals, and may conduct investigations. The CBRC is in charge of regulating banking services. Art. 2 LoBRS specifies the Banking Regulatory Authority under the State Council as the agency conducting the supervision on national banking institutions and their business activities. The LoBRS gives the CBRC effective means at hand to set prudential rules and to conduct banking supervision (Brehm and Macht 2005).

The CBRC began to set up a range of new regulations a.o. the Regulation Governing Capital Adequacy of Commercial Banks (New Capital Rules, NCR), which came into effect on 1 April 2004 and the Guidelines on the Management of Market Risk in Commercial Banks that became binding by the end of 2007. The new legal framework addresses the most important risks arising from banking business. According to Art. 11 of the Guidance for Internal Control of Commercial Banks financial institutions in China need to have models in place, which enable them to measure and control credit risk, market risk (also called systematic risk), operational risk and liquidity risk. Banking institutions are not required to actively manage other risk types such as counterparty risk or legal risk. This is in line with international practice, since risk-management-systems in leading U.S. and European financial institutions also focus primarily on interest- and exchange rate risk (as the two most important determinants of systematic risks), credit risk, and liquidity risk (Santomero 1997). More important, however, is the way in which the CBRC addresses regulatory issues compared to the PBC as its predecessor. The latter issued regulations that basically represented the operationalization of the Chinese Communist Party Central Committee’s Decision on Issues Concerning the Establishment of a Socialist Market Economy from 1993, which is the constitutional document for China’s financial market reform. Requirements focused on structural adjustments that would facilitate goals or tasks such as prudent risk management, while banks were left with the discretion to decide about implementation methods. Hence PBC-regulations intended to induce reforms by organizational restructuring. Rules issued by the CBRC have a more technical nature and elaborate on methods or standards for eligible methods. The new watchdog refers to aspects on how to measure risks and how to calculate respective loss provisioning and less on how to organize respective functions.

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2 The term ‘banking institutions’ is not defined within the LoPBC, but within the LoBRS (Art. 2).
3 According to Art. 32 LoPBC, the PBC has the authority to monitor financial institutions’, other groups’, and individuals’ activities concerning the implementation of administrative rules on reserve funds, Renminbi, inter-bank call and securities markets, foreign exchange, gold, clearing, fighting money laundering as well as activities concerning the management of State treasury.
4 SOCBs and JSBs are required to implement the law by the end of 2007 and CCBs as well as other commercial banks by the end of 2008.
5 Zhonggong zhongyang guanyu jianli shehui zhuyi shichang jingjing tizhi ruogan wenti de jueding. Issued 14 November 1993.
3. Regulation Based Incentives

With the CBRC assuming responsibility for banking regulation and supervision China moved into line with international best practice (Brehm and Macht 2005). It is, however, unclear whether the new legal framework on risk management addresses the shortcomings in Chinese state banks since international rules and global standards dealing with financial systems are based on the assumption of independent supervisory authorities (Brehm 2007). By contrast, the CBRC assumes a conflicted role as supervisor and state agent. The interpretation and enforcement of regulations are, therefore, not only bound to maintain financial stability but are also subject to political interpretation of economic needs. Thus the CBRC’s de-facto authority to rein in imprudent risk management is more limited than legislation reflects. As a consequence regulatory forbearance emerges as a systemic deficiency driven by three factors – state involvement in the formulation of prudential regulation, unsettled administrative relations between the central and the local level, and distorted incentives as a result of the politicized target to reduce NPLs.

a) Regulatory Forbearance in the Context of the CBRC’s Role as State Agent

Rules and regulations issued by the CBRC mirror her dual role as supervisor and state agent. On the one hand supervisory practice is moving into line with global standards but on the other hand there are also administrative guidelines that erode the legal basis for enforcement of prudential requirements. Art. 15 LoBRS stipulates that “the banking regulatory authority under the State Council shall, in accordance with applicable laws and administrative regulations, formulate and promulgate supervisory rules and regulations for banking institutions.” Thus a simple guideline of the State Council can already provide the legal basis for the CBRC to act within the context of political objectives. The design of administrative structures, therefore, allow for fast adjustments of supervisory processes and prudential requirements to support state policies. The almost inevitably arising contradictions between legislation and the CBRC’s objective to “promote safety and soundness of the banking industry” (Art 3, LoBRS) only recently became evident with the promulgation of the Guidelines on Banks’ Lending to Small Enterprises (SELG), which demands that all banks (policy banks, commercial banks and rural cooperative banks (Art. 2 SELG)) establish specialized departments that will undertake small enterprise lending activities (Art. 5 SELG). Most interestingly it was the CBRC that promulgated the SELG. CBRC chairman Liu Mingkang stressed that these regulations “should not be seen as a call or a political campaign to achieve broader social objectives” (CBRC 2006f); it is, however, difficult to perceive the guideline’s aim to “promote and
direct banks to provide financial services to small enterprises” (Art. 1 SELG) in a
different way. Another recent example is the Guideline on Improving Financial
Services of Commercial Banks to High-Tech Enterprises enacted by the CBRC in
December 2006. According to Art. 4 commercial banks shall promote the
National Medium and Long-Term Strategy for the Development of Science and
Technology (2006-2020) in providing loans for firms’ innovative activities. The
potential impact of these developmental regulations on risk management practices
will be discussed in section 6. Suffice it here to note that the CBRC’s “second
role” as a state agent defines loyalties and supervisory criteria that are distinct
from an exclusively rules-based approach to financial stability. The CBRC’s
authority to reign in imprudent risk management, therefore, does not extend into
politically prioritized fields of economic development.

b) Regulatory Forbearance in the Context of Unsettled Central-Local Relations

Since the 1980s there have been several tax-sharing contracts between the
central government and local governments. All changes, however, maintained a
trend of increasing budgetary pressure on local governments while Beijing
improved its fiscal balance considerably. The ratio of sub-national to total
government spending in China stands at more than 70% compared to around 30% in
OECD countries or 15% in developing countries. With respect to expenditures
China is therefore more decentralized than most nations in the world (Wong and
Bird 2005). Squeezing the revenue base of local governments in absence of an
alternative transfer system, however, increases pressure on state bank branches to
finance communal budgets. Even though the budget law from 1994 forbids local
governments to borrow directly from financial institutions, they still accumulate
liabilities through their enterprises. Ong (2006) stresses that local government
debt is poorly understood with respect to its origins, causes and magnitude due to
the high proportion of contingent liabilities such as debts of townships and village
enterprises (TVEs). These debts are not included in the financial statements of
local governments, though they bear the ultimate responsibility in case of default.
The CBRC may have the legal means and technical capacity to eliminate such
“back-door” lending. It is, however, questionable whether it can exert its authority
in the current situation, since alternative financing sources for local governments
stand in conflict with reforms that enjoy a higher priority on the political agenda
of the central government.

To remedy fiscal pressure local governments collect fees from firms and
peasants because this income category remains exclusively at their disposal.
There are several thousand fees that are prone to aggravate income inequality and
breed corruption. In recent years excessive fee collection has lead to revolts and
cased the death of fee collectors and farmers (Lin 2005). The central government
issued several regulations to levy unauthorized fee collection and announced a “tax-for-fee” reform. The enforcement of these measures, however, has been disappointing (Liu et al. 2006, Walker 2006), which puts the central leadership and its populist campaign of the “harmonious society” under increasing pressure. In this context, it is unlikely that the CBRC will receive political approval for a harder stance towards state banks that continue to lend to local governments, as this move would provoke an expansion of fee-collecting activities.

Another important capital source from which local governments could draw is the informal financial sector. Tsai (2006) estimates that at least 25% of all financial transactions in the Chinese economy are conducted through the curb market. The spread between the official and informal lending rates decreased from 36% in 1988 to 5.49% in 2003, which indicates an increasing supply and professionalization of curb market finance. Informal loans, however, have serious consequences for the national economy since they undermine the central states capacity to maintain macroeconomic stability. To tackle this problem the State Council established a committee against “illegal fund-raising” in January 2007 comprising of 18 officials from central government ministries and chaired by the CBRC (CBRC 2007). The group is supposed to draft and revise laws on fund-raising activities, which indicates that the State Council aims at a stronger criminalization of informal finance in respective rules and regulations. For law enforcement the central leadership relies on local governments. Communal cadres, however, have been reluctant to crackdown on the curb market since respective institutions improved access to capital for local businesses and therefore had a positive impact on their revenues. Local governments’ incentives to comply with central state’s efforts to shift lending to the formal sector would be even weaker when they themselves relied on informal finance.

c) Regulatory Forbearance in the Context of NPL Reduction Targets

Until 2003 the Chinese central leadership opted for a gradual approach to restructure the four state banks. SOCBs partially got rid of their NPL burdens but the major share they still have to handle themselves. In 1998 the Ministry of Finance (MoF) issued RMB 270 billion of special government bonds to recapitalize state banks (Mo 1999). One year later SOCBs transferred RMB 1.3 trillion of bad debts to four newly created asset management companies (AMCs), each of which was associated with one of the big four SOCBs (Bonin and Huang 2001). The first wave of capital injections equaled about 23% of total state bank loans in 1999 – the NPL-ratio, however, remained, with more than 30%, very high. Proponents of a partial recapitalization argue that the remaining debts will

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6 The informal lending rate refers here to the curb market in Wenzhou (ACBF 2005).
impose pressure on the management to improve efficiency and help to ‘outgrow’ the problem. Gradual restructuring, however, can also restrict a financial institution’s ability to conduct internal reforms when too much of the resources are bound to loan-loss-provisioning (OECD 2002: 463). As a consequence regulatory forbearance becomes more likely since the supervisory body has few choices other than allowing banks to continue operating irrespective of their financial status. To prevent moral hazard behavior among bank managers former Premier Zhu Rongji set ambitious targets to lower the NPL-ratio and requested them to implement responsibility systems in SOCBs that would enable supervisors to punish imprudent risk management with wage reduction and even the termination of employment.

In 2001 Dai Xianglong (governor of the PBC at that time) substantiated Zhu’s policy in demanding a year-on-year reduction of NPL-ratios between 2 and 4% (Shih 2004). Such administrative measures proved to be counterproductive since SOCBs could not possibly improve risk management and portfolio quality over night. To fulfill the harsh targets state bank managers therefore had an incentive to extend overall lending rather than to reduce the absolute amount of non-performing loans (figure 1).

Figure 1: NPL development in China’s SOCBs

Credit expansion *ceteris paribus* is connected to a decreasing marginal return, which means that more prospective non-performing investments receive funding. The development of the capital adequacy ratio (CAR) of the four SOCBs after the first wave of capital injections in 1998/1999 indeed gives some
indication that accelerated lending was not associated with prudent risk management. Within only three years the absolute amount of NPLs increased from RMB 1.6 trillion to more than RMB 2 trillion (figure 1) while the CAR fell from 7.01% down to 4.27% (table 1), which is significantly below the 8% requirement of the *Basel Capital Accord*.

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<tr>
<td>CAR</td>
<td>3.75</td>
<td>3.85</td>
<td>3.71</td>
<td>7.01</td>
<td>6.89</td>
<td>5.51</td>
<td>4.35</td>
<td>4.27</td>
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Source: Wang (2003), 30 and OECD (2005), 146

State policy towards reforming SOCBs changed when Wen Jiabao assumed office as premier in 2003. Since then state banks have received an additional RMB 1.2 trillion in order to make a new start possible. In 2003 the PBC injected USD 60 billion out of its foreign currency reserves in exchange for equity. One year later an additional RMB 780 billion in doubtful loans were transferred from three of the four state commercial banks to the AMCs (Ma 2007). After that, the CAR leapt up to 6.8% in 2004 and the NPL-ratio dropped to 10.49% by 2005. Independent estimates, however, diverge considerably from the official figure of around USD 225 billion or 7% of GDP in 2005. For example, Ernst & Young published a report in 2005 stating that the amount of NPL stood at USD 911 billion or 41% of GDP. Fitch Ratings calculated NPLs of USD 673 billion, or 27% of GDP as of 31 March 2006 (Setser 2006) and Standard & Poor’s estimated an amount of USD 500-650 billion at year-end 2005 (Petit 2006). Whatever the true figure is, estimates indicate that the state of Chinese banks is still far from being solid. The new reform strategy, therefore, emphasizes the importance of institutional change that induces a shift in incentives. An essential component of the new strategy is to improve risk management through a changing ownership structure and intensified competition. In the following pages these incentives will be discussed in more detail.

### 4. Corporate Governance Based Incentives

The role of private shareholders for economic performance is based on the observation that a separation of ownership and control in corporations often leads to a situation where the interests of owners and managers diverge (Berle and Means 1932). Agency theory as formalized by Jensen and Meckling (1976) show that agency costs increase when managers do not have a stake in the firm. Private shareholders are residual claimants and bear full responsibility for their own losses. This creates strong incentives to monitor executives closely or, in case of manager-owners, to employ strategies that maximize the shareholder value. By
contrast, public ownership can foster incentives for moral hazard behavior when politicians are supposed to act as custodians of the people and take on monitoring functions. Politicians, however, do not benefit from maximizing the shareholder value and they are not accountable for rising losses. These weak incentives to improve a public firm’s economic performance is aggravated by the fact that politicians can extract rents from corporations either in order to increase private cash flows or to employ them for power-preserving measures. Thus most empirical studies find evidence that private ownership and/or management-ownership has a positive impact on economic performance (Morck et al. 1988).

In line with these arguments the Hu Administration opted for a partial privatization of China’s state banks to improve corporate governance and risk management. The government began to de-vest its ownership stakes in 2003 and sold 14.1% of the China Construction Bank to the Bank of America and Temasek in exchange for USD 3.966 billion in equity, 16.84% of the Bank of China to four foreign shareholders for USD 5.22 billion and 10% of the Industrial and Commercial Bank of China to a consortium led by Goldman Sachs for USD 3.6 billion. Hence only the Agricultural Bank of China, which is the financially weakest institution among the four SOCBs remains solely state-owned. The privatization of China’s state banks was widely praised among politicians and economists as a step in the right direction and a chance for an eventual turnaround in state bank management. This point of view might be rather over optimistic since the improvement of corporate governance through the participation of globally active financial institutions requires that new investors have different incentives and more effective means to facilitate prudent risk management. A closer look on the incentive structures in China’s political economy, however, reveals factors that may compromise this mechanism substantially.

a) The State as the Main Shareholder

The central leadership is under considerable pressure to present privatization as a successful means for banking reform. Naughton (2006) gives an account on a shift to the left in public discussions concerning financial reform and, in particular, the sale of bank stakes to foreign investors at its core. Though neo-liberalism critique so far did not change the overall course of the central leadership Hu Jintao still was forced to stress the ‘scientific development concept’ rather than the ‘harmonious society’ during the XVII party congress in autumn 2007 in order to advocate reforms indicating that he has been defeated on an issue closely connected with him (Fewsmith 2008). Recent fractional power struggles have a significant impact on banking reform, as the central government needs to push for fast deliverables in order to maintain public and political support. The
resulting short-term orientation of political action becomes evident in the *Guidance for the Governance and Supervision of State Owned Commercial Banks* (GaS-SOCB) issued in April 2006. These regulations define minimum performance criteria such as an NPL-ratio underneath 5% (Art. 6.1) and a return on assets of at least 0.6%. Improvements in risk management, however, are incompatible with these short-term goals, because the development and implementation of appropriate techniques, the training of credit officers to apply respective procedures correctly as well as the establishment of effective internal monitoring systems are time and cost intensive. Furthermore any profitability measure is calculated after loan-loss provisioning. During the first years a shift to prudent risk management therefore would reduce profits and in addition increase the NPL ratio because, as section 6 will show, there is probably a significant amount of doubtful loans that have not yet been discovered or correctly categorized.

*b) Foreign Strategic Investors*

In the current situation foreign equity participation is also unlikely to bring about substantial changes in risk management. Foreign investors are restricted to participation as minority shareholders due to a 25%-ceiling of overall involvement and a 20% limit for a single financial institution. Opper (2007) therefore questions whether foreign investments suffice to change corporate culture and implement modern governance-techniques. Theoretically foreign shareholders could also improve risk management when they expose banks to market discipline by opting for exit. This mechanism, however, is not effective in China because strategic foreign investors have to keep their shares for at least 3 years (Art. 6.2 GaS-SOCB). In addition the criteria that define eligible foreign financial investors and the fact that the CBRC has to approve respective requirements creates lock-in effects, as stocks cannot be traded anonymously. Thus foreign investors face a ‘lemon problem’; they only can sell their shares with a discount since a potential buyer would always assume that the foreign investor has insider information about the real state of the bank and potential profits. But even if managers and shareholders of foreign financial institutions could have more influence on corporate decisions, they still might not be interested in exerting this power for the sake of financial stability since this goal stands in conflict with short-term shareholder value. Improving risk management requires that foreign investors engage in costly restructuring, which obstructs profits and hence the quick reduction of their overall investment risk. Foreign investors, therefore, may rather aim at socializing the costs for risk provision by making use of political lock-in effects and lobby for market protection and regulatory forbearance as a means to improve performance and maintain stability.
c) **Top-Management of State Banks**

Incentive structures for managers raise doubts that SOCBs are at a turning point. A post as a top-manager in a state bank is a step in a political career. CEOs of leading corporations have the rank of a vice-minister, vice-provincial governor or above, and the chairperson of a SOCB serves at the same time as party secretary of the respective corporation (Li 2005). Hence it is the party leadership that appoints state bank managers, which ensures political loyalty. A CEO stays for only a few years before aspiring to a higher-ranking post in the party or government organization. Currently the most senior CEO in China’s state bank is Yang Mingsheng who has been in office since 2003. The political nature of top management positions ensures congruent interests of state banks’ executives with the government as the main shareholder. This alliance, however, obstructs a shift to effective risk management due to the short-term orientation of political incentives with respect to banking reform.

5. **Market Based Incentives**

In many transition economies competition has been more important than change of ownership to provide managers with appropriate disciplinary mechanisms (Stiglitz 2000). But increasing competition in connection with implicit state guarantees might also enhance the probability of a ‘gambling for resurrection’. When new banks enter the market the franchise value of incumbent institutes decreases, which is negatively correlated with an overall willingness to take risks (Keeley 1990, Demsetz and Saidenberg 1996). Such a ‘gambling for resurrection’ worsens the portfolio of national banks when foreign competitors attract most of the profitable customers while leaving the bad risks to national banks (Claessens et al. 2001, Goldberg et al. 2000, Demirgüç-Kunt and Detragiache 1998). Even though the special nature of finance raises some doubts on the unambiguous positive effects of competition, most of the empirical findings, however, suggest a positive correlation between market liberalization and efficiency. Claessens et al. (2001) show that international banks enhance the quality and variety of financial instruments in transition countries. Furthermore market openness improves financial portfolios and forces domestic banks to innovate new products and reduce costs (Claessens and Glaiessner 1998, Montreerat and Rajan 2001).

Intensified competition in the Chinese banking sector rests on the introduction of market prices, incentives for active asset management, and increased competition. In 1996 the PBC began to free the interest rate in the inter-bank market. Since then price ceilings on the bond repo market, on foreign currency lending and deposits were lifted gradually. Beginning in 1998 the PBC
reduced reserve requirements from 20% to 8% and one year later to 6%. Also excess reserves were lowered to discourage banks from hoarding liquid assets. Furthermore SOCBs were given more responsibility for their lending decisions and credit quotas were partially abolished. In 1999 private capital was allowed to enter Joint Stock Commercial Banks and City Commercial Banks. Additionally China took further steps to open its banking market for foreign financial institutions in 2002. According to the country’s WTO-commitments all restrictions discriminating foreign banks with respect to market entry and business operations have been lifted end of 2006. Despite these institutional changes the banking market remains restricted, which helps to preserve the dominant position of the four state commercial banks.

a) **Price- and Product Competition**

Price competition is hampered through an upper limit on deposit rates and a lower limit on loans in domestic currency in order to ensure a minimum profit margin. On the one hand fixed interest rates may help to prevent a gambling for resurrection; on the other they undermine incentives for improved risk management since banking institutions cannot use a superior cost structure to increase their market share and thus enhance the pressure on incumbents to catch up. The CBRC also regulates prices for financial services according to the *Provisional Rules Governing the Pricing of Commercial Bank Services.* Art. 6 of these regulations states that “the pricing of a commercial bank’s service shall be either administered by the government or determined by market depending on the nature of the service and the situation of market competition”. Regulated prices for provision-based financial services may reduce incentives for improved risk management if the four state banks constitute the benchmark for evaluating “the situation of market competition”. Another drawback is the weak protection of intellectual property rights, which reduces incentives for financial product innovation and thus hampers intensified product competition. The *Guidelines on Financial Innovation of Commercial Banks*, enacted in December 2006, define deficient legal safeguards in merely stating that “commercial banks shall respect intellectual property rights of other parties as well as their own” and that “commercial banks should establish an effective strategy of protection of intellectual property rights” (Art. 12). No references to measures for enforcement mechanisms or the possibility for legal actions are made.

b) **Domestic Competitors**

Joint Stock Banks (JSBs), currently the biggest competitors of SOCBs, are mainly disadvantaged due to regulatory liquidity constraints. The business
expansion of JSBs relies on the amount of savings that they are able to collect. As they do not have a vast branch network like SOCBs to gather household savings, they mainly rely on corporate deposits. Firms, however, are only allowed to have one account, which they usually keep at the bank that is most important for their funding. Since SOCBs provide by far the highest amount of loans they are in an advantageous position to receive corporate deposits as well. Another potential source for additional liquidity is central bank loans. JSBs, however, face also in this respect a disadvantage. They receive rather few funds from the PBC (table 2), which constitutes on average (1999-2004) 3% of the loans to state banks even though the market share of JSBs with respect to assets stands at about 10%, and with respect to loans at about 20% compared to 50% and 60% respectively for SOCBs.

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<td>Joint Stock Banks</td>
<td>129,3</td>
<td>96,8</td>
<td>73,3</td>
<td>326,1</td>
<td>15.5</td>
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<td>State Commercial Banks</td>
<td>7559,8</td>
<td>8120,5</td>
<td>8358,2</td>
<td>3165,3</td>
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Source: Almanac on China’s Banking and Finance (various issues)

c) Foreign Competitors

Foreign competitors also face considerable obstacles. High minimum capital requirements for bank branches\(^7\) and the earlier mentioned limits on equity investments restrict their attempts to penetrate the market. Their market share with respect to assets is still less than 2%. A significant change in this situation is unlikely, at least for the coming years, since the supervisory authorities seem to be prepared to restrict market access by economic need tests, despite prohibition according to WTO-regulations. In April 2006 CBRC Vice Chairman Tang Shuangning explained the supervisory body’s regulatory view on private capital entry into the banking industry. He outlined that the CBRC understands capital entry and institutional entry as distinct concepts. With respect to the latter the CBRC holds the view that she has “to be prudent from the perspective of protecting the interests of depositors and guarding against financial risks, given that the number of banking institutions in China has on the whole approached the point of saturation […]”. (CBRC 2006b). Thus the CBRC regards the regulation of competition through restricted market access as a legitimate way to facilitate

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\(^7\) A universal banking license in China requires a capital commitment of 500 million RMB per branch, which, for instance, exceeds requirements for the same kind of license in Switzerland by more than 700%.
prudent regulation.\textsuperscript{8} This argumentation, however, is probably not shared by other WTO-members and it most certainly distorts incentives for SOCBs to improve in-house risk management.

6. The Impact of Banking Regulation on Risk Management Practices

The previous sections have showed that the current reform design bears four major deficiencies. Firstly, current regulations stick to the tradition of formulating administrative performance criteria such as a maximum NPL-ratio. This approach certainly generates incentives for misreporting and forbearance as previous experience during the Zhu-era showed. Secondly, additional performance criteria, as for instance a minimum return on assets, do not contribute significantly to banking reform because they are basically the result of NPL-reduction. State banks are less profitable than JSBs due to the large share of returns that they have to employ for loan-loss-provisioning. Therefore the massive recapitalization since 2003 improves state bank performance without any efficiency gains and hence reduces incentives for restructuring and prudential risk management. Thirdly the full opening of the banking sector for foreign financial institutions by the end of 2006 will not impose sufficient market discipline as a stick to enhance efficiency because competition will remain restricted. And fourthly the CBRC is more limited in its authority to reign in imprudent lending practices than legislation reflects due to her double role as supervisor and state agent.

In the following pages I turn to the consequences of regulatory capture for financial stability. In parallel to the three systemic deficiencies of banking supervision as outlined in section 3 we can identify three factors that are likely to worsen the performance of state bank portfolios beyond the currently expected and categorized write-offs, namely inadequate pricing for loans granted under political initiatives, declining credit worthiness of local governments and risk averse strategies of state banks to fulfill performance targets.

a) Political Initiatives

Despite the fact that banks are required to manage risk for their own account the freedom to compose portfolios has been limited in the past and is still limited today to a certain extent. Domestic banking institutions in general, and SOCBs in

\textsuperscript{8}The Chinese representative at the WTO emphasized during the transitional review under section 18 of the protocol on the accession of the PRC in September 2005 that China has the right to regulate its financial services through measures based upon prudential principles. This argument refers to Art. 2 (a) of the annex on financial services in the GATS stating that market restrictions for prudential reasons are permitted notwithstanding other commitments made in the treaty.
particular, operate on a conflicted legal basis, which makes it difficult to define ultimate responsibilities. Art. 4 of the *Law of the People’s Republic of China on Commercial Banks* (LoCB) states that “commercial banks shall make their own decisions regarding their business operations, take responsibility for their own risks, assume sole responsibility for their profits and losses and exercise self-restriction.” Article 34 LoCB, however, demands, “commercial banks shall conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State.” The efficiency of the state banks’ portfolio therefore depends on the role the state assumes in the capital allocation process.

Legislation and the statements of high-ranking officials reflect the central government’s claim to adopt state banks as an instrument to develop backward regions. In this context the CBRC is supposed to mediate political objectives towards the banking sector. In recent years this role became apparent in the supervisory agency’s support for the “go west” strategy, urging banking institutions to enhance their contributions to local economic development in six poor provinces and autonomous regions. The regulatory body relaxed market entry conditions for financial institutions in respective regions and campaigns among state banks to promote “the construction of a new socialist countryside.” (CBRC 2006d, 2006e).

Earlier political initiatives of a similar kind resulted in promoting loans that incorporated high default risks without the possibility for SOCBs to charge adequate risk premiums. In 2001, for instance, the central government initiated an agricultural loan campaign to bolster the rural economy. Since then outstanding loans to the agricultural sector rose from USD 60 billion up to USD 145 billion in 2005. Though these loans are labeled ‘agriculture’ they, however, exceed the value of agricultural fixed asset investments and farm input expenditures by about USD 30 billion.\(^9\) This gives rise to the presumption that a substantial share of agricultural loans is used for consumption. Furthermore increased investments did not have any significant effect on productivity (Gale, 2006), which points to low returns on investments and thus to a high default risk. Of course, it is not problematic per se that the central government devotes resources to promote the development of poor regions. However it is problematic that it aims at involving state banks that are supposed to shift to a commercial business concept, rather than employing the states’ three policy banks that conduct lending with explicit state guarantees.

Likewise, state guidance that compensates – in a Gerschenkroinan sense – for market imperfections undermines prudent credit risk management, since political capital allocation leaves the ultimate responsibility for making losses in

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\(^9\) Author’s calculation based on various issues of the *Almanac on China’s Banking and Finance* and the *China Statistical Yearbook.*
the public sphere, notwithstanding the motives behind such practices. For example, the recently enacted *Guidelines on Banks’ Lending to Small Enterprises* (SELG) aims at thwarting ongoing capital misallocation, particularly in SOCBs. In 2005 there were more than 29 million private businesses in China, employing over 200 million people and producing almost 50% of GDP. But by mid-2006 only 1% of all loans extended by state commercial banks were going to the private sector (Tsai 2006). The situation is about to change with the new loan promotion scheme, which directed 141.2 billion or about 10% of all new loans to small firms during the first six months of 2006 (CBRC 2006a). Thus, while the CBRC performs as an effective means to implement policy goals, she fails at the same time as a prudential regulator, since she leads SOCBs into credit decisions, which are beyond their risk management capacities as a result of inadequate techniques and skills, as well as severe information asymmetries. On-site supervision of the CBRC conducted in state bank branches in 5 cities (Xi’an, Dongguan, Taizhou/Wenzhou, Beijing and Weihai) supports this concern revealing that on average 64% of the capital provided to small and medium size companies was non-performing (ACBF 2005).

The *Guidelines on Improving Financial Services of Commercial Banks to High-Tech Enterprises* are also likely to have a negative impact on the credit risk exposure of state banks. Even though Art. 2 states that banks are accountable for their own losses and profits, it is unclear whether this claim can be enforced. Investments in innovation, and in particular in frontier technology, bear high risks. Innovation finance, therefore, is usually taken on by venture capitalists with superior knowledge in the respective sciences. Venture capitalists are residual claimants with strong incentives to closely monitor a firm’s activities. In contrast banks do not have access to relevant technical expertise to appraise innovation projects and, since they receive only fixed interest payments, enhanced surveillance is not cost efficient for them. The *Guidelines*, therefore, require financial institutions to be accountable for downside risks without appropriate compensation. As a consequence SOCBs will rely on state bailouts, as it is unlikely that they can succeed in managing the risks arising from high-tech development.

**b) Local Government Lending**

Local governments have a strong interest in intervening in loaning decisions as a result of administrative and fiscal reforms during the 1980s. The policy of ‘eating in separate kitchens’ provided local governments with considerable budgetary autonomy, which encouraged them to promote the setup of local industries and to engage in entrepreneurial activities (Oi 1995). Local cadres further economic growth within their jurisdictions because they benefit
from bonus payments that are based on retained earnings, and also because they rely on additional income to finance the communes’ increasing responsibilities for social services and public goods provisioning. Loans are, however, granted in consideration of a local developmental context that often results, from a national viewpoint, in inefficient small-scale production, investment in over-capacities, regional protectionism and cyclical overheating of the national economy.

Restructuring of the banking system since 1993 reduced the formal possibilities of local cadres to influence credit decisions. Informal ties, however, remain and obstruct credit officers incentives to exclusively focus on risk and corporate profitability (Huang 1999). A survey conducted by the PBC in 2005 underlines this problem in stating that more than 80% of NPLs could be attributed to conflicts of interest and directed lending (Petit 2006). As pointed out in section 3, local governments in particular make use of their township- and village enterprises as a vehicle to borrow money from state banks. Recent estimates of local government debts points to an amount of USD 120 billion or 5.5% of 2005 GDP (Ong 2006). Due to the contingent liabilities in TVEs this figure, however, may understate the real situation considerably, which makes local governments presumably one of the largest uncovered risk factors in state banks’ credit portfolios.

This threat is aggravated by local governments’ investment hunger and the resulting oversupply. While commodity prices grew by almost 10% until the end of 2004 there was a slow down in this development to 0.2% until mid-2006 (PBC 2006). Credit and investment growth in connection with falling commodity prices raise concerns that a new wave of non-performing loans is about to emerge. About 10-20% of investments are based on “package loans” as another form of indirect government lending through local construction and investment companies and guaranteed by local finance bureaus. Despite the doubtful financial state of local governments, SOCBs perceive risks arising from this loan category as rather low because of local governments’ fixed revenue streams and the assumption that the central government will bail them out when things go wrong (World Bank 2006).

c) Risk Averse Strategies of SOCBs

Bank lending in China takes place in an increasingly opaque environment. It remains difficult for financial institutions to evaluate the credit quality of private firms. Even though China made some efforts to implement international accounting standards, accounting practices still diverge (Chen et al. 2002) and enforcement mechanisms remain weak (Opper 2003). The world business survey indicates that financial statements are less standardized than in any other country in East Asia. 58% of the participating firms did not use an external auditor for
their financial statements and almost 90% were not complying with the International Accounting Standards (IAS).

At the same time an increasing number of former SOEs are dropping out as creditworthy customers. Traditionally SOCBs provided most of the investment funds as well as the working capital for SOEs (Mehran et al. 1996: 11). Bank loans constituted a convenient way for the central government, as well as local governments, to provide social services for workers and their families, without the respective costs appearing on the balance sheet (Lardy 1998: 34). Since the late 1990s SOE reform, however, dismantles the concept of tying social services to employment (Xu et al. 2005). In the process of privatization and corporatization of SOEs, workers depend on the mercy of decision makers, with the actual institutional outcomes mainly a result of bargaining and collusion between local bureaucrats and managers (Cheung 2005). Because SOE reform has significant distributional effects and various interest groups aim at shaping respective processes to their advantage, the overall restructuring is often opaque and it remains unclear whether funds will be used for turn-around management, rent extraction from local politicians and managers, or for maintaining social stability.

The uncertain future prospects of many companies and the potential for misuse of funds during firm restructuring makes state banks hesitant to lend to companies in transition. Instead they concentrate their funds on large SOEs that have been selected as key companies based on the “zhuada fangxiao” (“keep the large and let the small go”) policy, or on large private companies. Lending patterns in China, therefore, remain distinct from other countries in the sense that in the latter banks tend to extend most of their loans to households and small- to medium-size private firms, while in China 64.5% of outstanding loans at year-end 2005 were extended to SOEs (Setser 2006).

The effects of this strategy are ambiguous. On the one hand there are empirical indications that focusing on large corporations reduces (individual) risk exposure. Based on an annual survey of 20,000 large and medium-size industrial enterprises in China, Xiao (2005) shows that the non-performing debts of firms have been falling since 2000. Given that this sample comprises more than 43% of the total loans in China’s financial institutions, it implies that portfolio quality is improving. On the other hand such lending practices increase the problem of connected lending and hence compromises the (expected) credit portfolio performance. In June 2005 the four SOCBs, the China Development Bank and 12 shareholding banks had 16,416 customers with more than RMB 100 million exposure. This group consists of 0.5% of the total customer base but represents almost 50% of the total amount of loans outstanding. The average exposure among large customers is RMB 446 million, up 27 million in the first half of 2005 (CBRC 2006c).
Another strategy in state banks to reduce risks is to connect bonus payments and career prospects of credit officers to their individual default ratio. Paradoxically this incentive scheme worsens portfolio quality. Figure 2 illustrates that reform measures taken under Hu Jintao in 2003 brought credit growth to a halt and stabilized it on a lower level. This could be interpreted as a shift towards more prudential lending practices. At the same time, however, the ratio of long-term to short-term lending continues to rise. This lending pattern is counterintuitive in a fast changing environment such as China’s transition economy where one would expect a bias towards short-term lending. A possible explanation for this paradox is that the rather basic risk management techniques in state banks tend to identify non-performing loans only when they are due. Credit officers can make use of this loophole to improve their individual performance through long-term lending. If the potential event of default occurs several years ahead the responsible credit officer most likely has changed to another position and hence will not be impacted by reduced bonus payments and delayed career advancement.

Figure 2: Loan Growth and Risk Aversion

Source: Statistics of the People’s Bank of China (http://www.pbc.gov.cn)

7. Conclusion

In many respects banking reform in China is consistent with economic wisdom. Regulation is shifting increasingly from an economic to a prudential concept, state-owned commercial banks have been partially listed on the stock exchange, and discrimination against foreign banks and other domestic financial institutions has been reduced. The central leadership went all the way with none of these reform measures but relies on its well-proven policy of inducing change
gradually. Thus from a normative perspective one may argue that banking reform will progress over time and eventually facilitate a sound financial system.

Lending behavior, however, indicates that there is a gap between the direction of action in banking reform and ongoing practice, particularly in Chinese state banks. This paper therefore aimed at challenging the economic-normative viewpoint and elaborated on the effectiveness of reform measures to prevent ongoing accumulation of NPLs and inadequate loan-loss-provisioning in a wider political context. A closer look at the institutional setting in which bank reform is embedded proved that the way to financial stability is not that straightforward. Incentives to establish and enforce prudent risk management are weak. This is not a question of gradualism, and hence a matter of time in the first place, but relates to the specific institutional settings and preferences of the ruling political and economic elite, as well as the blurred boundaries between them.

Analyzing banking reform in China against the background of academically and empirically well-founded reasoning on how to promote a transition towards sound banking may be at fault, simply because the assumption that it is all about efficient capital allocation is not valid. Political forces in China seem to be in search of a banking system that is responsive to state guidance and implements the respective initiatives and policies that are economically advantageous. Thus policy recommendations framed in a normative-economic concept may miss the point that structural change does not necessarily focus on market efficiency but on something that can be called ‘political efficiency’ – that is the construction of a system that employs market mechanisms and economic rationality to achieve political effectiveness.

Addressing the issue of financial stability by promoting international best practice is not sufficient because systemic and institutional particularities only allow for an eclectic implementation of global standards and international rules. As a consequence the outcome of reform becomes rather random. Though banking regulation and bank reform in China is a specific case there is still an important general lesson to be learned – that the institutional embeddedness of reforms matters. Though this finding is not really new there are, however, almost no efforts, either in the mainstream literature on banking regulation or from practitioners in international organizations and groups dealing with the formulation and definition of best practices, to sufficiently account for this fact. Formulating an agenda for financial sector reform thus needs to elaborate into new fields and explore possibilities to formulate recommendations that are compatible with state-ownership and state guidance as a political reality, or to engage in system critique as part of a normative approach to financial sector reform.

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Monetary Fund.


