Many positive and profound changes have occurred in China's financial sector in the past 3 years. When DB Research published “China's financial sector: Institutional framework and main challenges” in January 2004, scepticism abounded on the solvency of key Chinese banks, the health of the banking sector, and the future of banking sector reform.

China's banking sector today is looking much better, with improving financial fundamentals and structural changes, particularly in the ownership structure. Several Chinese banks have been pursuing internal reform in earnest. The main aim of the reform has been to prevent past mistakes due to lending decisions made on the basis of relationships from happening again.

Plenty of challenges remain despite recent progress. Strengthening the credit function and internal support systems is crucial for the Chinese banks' future success. Given current strong credit growth rates, capital adequacy should be raised further. Moreover, risk management, governance standards and credit culture in general are still emerging and are yet to be tested when the economy slows.

More consolidation lies ahead. There are synergies to be gained from mergers and acquisitions of Chinese banks. For example, some joint stock banks may have stronger financials, but lack regional or national footprints. Some city commercial banks may have good local networks, but are less sound financially. As competition intensifies, consolidation will be inevitable.

WTO opening measures will have a positive long-term impact. Competition for domestic bonds will certainly increase, but we do not expect an exodus of customers abandoning local banks for foreign banks. The latter still lack branch networks and are likely to initially concentrate on corporate banking areas such as loan syndication for large projects, treasury and private wealth management, as well as investment banking. Further out, we foresee more co-operations between foreign banks and sizeable local ones to tap into consumer banking, credit cards, and lending to local companies. These partnerships are expected to help local banks expedite the upgrade in their internal systems as well as foster product innovation.
I. China’s banking sector: Then and now

1. Bank lending is and will remain the Chinese economy’s dominant form of financing

China’s economic activity is primarily financed by bank loans. As of H1 2006, bank loans accounted for 87% of total funds raised by the domestic non-financial sector, up from 76% in 2001 (see table 1). The share of corporate bonds in financing has increased substantially, from less than 1% in 2001 to 6% currently. Government bonds, on the other hand have seen their share decline from 16% in 2001 to 1% during the same period. Fund-raising by equity issues has been erratic during this period due to ongoing reform in the stock markets. Its share in financing fell slightly from 8% in 2001 to 6% in H1 2006.

While the share of bank lending is expected to decline from its near 90% level today, bank loans are likely to remain the dominant form of financing over the next few years. The main reason is that the financial infrastructure to support other fund-raising instruments, in particular corporate bonds, will take years to develop. At 34% of GDP in 2005, the bond market size in China is small when compared to almost 200% of GDP in the US and Japan and 150% in the EU. A similar pattern is observed in the equity market: The size of China’s stock market capitalisation is still slightly below 20% of GDP compared with over 100% in the US and Japan and 75% in the EU (see chart 2). As the authorities expedite the reform of rules and regulations, the importance of market-based instruments such as corporate bonds and equity issues will grow. But bank loans will nevertheless continue to be the preferred fund-raising source by the real sector in the medium-term.

2. “Big 4” remain key players but joint-stock banks are making inroads

The structure of China’s banking sector has remained largely unchanged since 2003 in terms of key players. The state-owned banks continue to command the highest market share, although there has been a marginal decline.

The four big state-owned commercial banks, namely Agricultural Bank of China (ABC), Bank of China (BOC), China’s Construction Bank (CCB), and Industrial and Commercial Bank of China (ICBC), together accounted for 52.5% of the banking sector’s assets in H1 2006, down from 55% in 2003 (see chart 3).
Mirroring the small decline in market share of the big 4 is the increase in market share of the joint-stock banks\(^1\), which accounted for 15.9% of the banking sector’s assets in H1 2006, up from 13.8% in 2003. This seems to suggest that joint stock banks are expanding at the expense of the big 4. The latter have been constrained by their large non-performing loans legacy, which prevents them from expanding lending activities as quickly as their competitors.

City commercial banks\(^2\) accounted for another 5.7% of the sector’s assets as of H1 2006, up slightly from 5.3% in 2003. The share of assets held by other financial institutions has remained largely unchanged at around 26% (policy banks: 8%, rural credit co-operatives 11%, postal savings: 4%, foreign banks: 2%, other 1%).

Going forward, it is likely that the turf war for China’s banking sector assets will continue to be fought between the big-4 banks and the joint stock banks. The relevance of other domestic institutions will, at best, remain stable. Rural credit co-operatives will be undergoing a major consolidation exercise, which may see their market share decline further. Policy banks, meanwhile, are unlikely to show a big market share increase since the central government’s policy thrust has been to reduce their role in the financial system. In contrast, foreign banks’ share will possibly see an increase as the remaining restrictions on RMB businesses are lifted by WTO accession requirements in December 2006, as we discuss below.

In terms of deposits, the market shares are similar to those by assets. The big-4 banks, well supported by their extensive nationwide network, command the largest shares of retail deposits. Smaller banks compete for corporate deposits, which tend to be a more volatile source of funding.

3. **Big 4, big reforms: Towards a commercial credit culture**

Three of the big-4 banks have undergone major structural reform aimed at promoting a commercially-driven business culture. Reform has been implemented in the CCB, BOC and ICBC. Reform in ABC has been slower as its main assets comprise mainly loans to the agricultural and rural sectors, the restructuring of which will likely only be possible under a broader rural sector reform.

The reform roadmap for the CCB, BOC and ICBC comprises four main steps: recapitalisation, reform of internal structure, strategic partnership and stock market listing\(^3\).

**Recapitalisation**

The recapitalisation exercise started in December 2003 with a capital injection of USD 22.5 bn each into BOC and CCB by the central bank, the People’s Bank of China (PBC). The PBC transferred the funds from its international reserves to a newly created entity, the Central Huijin Investment Company (Central Huijin), which acts as the holding company for the government’s shares in BOC and CCB. A similar exercise was conducted in April 2004 for ICBC.

---


2 City commercial banks evolved from urban credit co-operatives. The scope of their business usually concentrates in the city in which they are located.

3 Moody’s Special Comment. Reform of China’s State Banks: Moving Beyond IPOs; Positive Rating Actions Likely. November 2005.
2005 with ICBC for a sum of USD 15 bn. As in the previous cases, Central Huijin is the shareholder of government's shares in the ICBC.

As a result of capital injection, the capital adequacy ratio (CAR) of these banks has improved. At end-2005, the CAR of the BOC stood at 10.42% (2002: 8.15%), CCB's at 13.57% (2002: 6.91%), and ICBC's at 10.26% (2002: 5.54%). Improvements in the capital adequacy ratio have allowed these three banks to write down their non-performing loans (NPL) faster. The NPL ratio of the big 4 fell from 19.2% in Q1 2004 to 9.5% in Q1 2006.

**Reform of ownership/internal structure**

Three of the big-4 banks – BOC, CCB, and ICBC – have changed from a wholly-owned state bank structure to a shareholding one. They are now referred to as state-owned commercial banks (SOCB) as opposed to wholly-owned state commercial banks previously. Other shareholders besides the Chinese government are now allowed to hold shares of these banks, but the state remains their largest shareholder.

Changes have been implemented to instill an independent credit culture and equip the credit managers with an appropriate system to monitor various elements of risks. These include the 10-plus loan classification system and plans to set up the internal rating-based (IRB) loan systems (consistent with Basle II regulations). The risk function has been separated from the business function. Internal audit and compliance systems have also been strengthened, by system upgrading and staff training, to install more effective safeguards against fraud. Generally speaking, improvements in governance and risk management are encouraging, but the process is still ongoing and remains a work in progress.

At the operational level, the big-4 banks have implemented changes to consolidate operations and increase efficiency. During 2002-2005 the number of branches of the big 4 has declined by 25% while the number of employees has declined by 7%.

**Strategic partnership**

The central government has welcomed greater foreign ownership in banks, but it is not yet willing to surrender majority control of key banks. The ceiling of foreign ownership was lifted in January 2004 to 25% from 20%. The ceiling for single foreign ownership was also lifted to 20% from 15%.

In addition to providing additional sources of capital, strategic partnerships with foreign banks are expected to help Chinese banks in product knowledge and innovation, expanding businesses and markets, as well as technology & know-how on internal management. Having a foreign partner on board is expected to give Chinese banks an additional impetus to behave under a more commercially-driven, profit-oriented business culture.

The reformed big-3 banks have had no trouble finding major foreign investors or strategic partners (see table 4). BOC’s major foreign

---


5 This system subdivides loans into credit quality levels on the basis of a five-tier classification, for example four levels for performing loans, three levels for special-mention loans, two levels for substandard loans, two levels for doubtful loans and one level for loss loans.

investors or strategic partners are Royal Bank of Scotland, Merrill Lynch, Li Ka-Shing, Singapore’s Temasek Holdings, Union Bank of Switzerland, and Asian Development Bank, which together hold around 16% of BOC’s capital. CCB’s major foreign investors or strategic partners are Bank of America and Singapore’s Temasek, which together hold a 14% stake of CCB. ICBC’s major foreign investors or strategic partners are Goldman Sachs, Allianz, and American Express, which together hold around 10% of ICBC’s shares.

**Listing on the stock market**

Listing on the stock market is intended to instill market discipline on Chinese banks. More specifically, it is expected to keep banks focused on delivering good value to shareholders. CCB is the pioneer among the big 4: It has been listed on the Hong Kong stock market since October 2005. CCB’s shares have performed well, up more than 40% (as of end-September 2006) since their launch. CCB is also listed on the Shanghai stock exchange. BOC has listed its shares on both the Hong Kong’s stock market since May 2006 and on the Shanghai stock market since July 2006. BOC shares have done well in both markets. ICBC made its debut on both the Hong Kong and Shanghai stock markets in late October 2006, raising USD 19.1 bn in its IPO, the largest in history. The listing was spectacular. The IPO was several times oversubscribed and the share price closed 15% higher on the first trading day. The encouraging performance of the three banks on the stock market, despite their unimpressive record on return on assets (0.6% for the big-4 Chinese banks, compared with 1-2% in other Asian banks) demonstrates investors’ faith in their long-term prospects.

4. **Reform of other commercial banks: Work in progress**

Internal reforms have not been limited to three of the big-4 banks. Joint stock banks and city commercial banks have also initiated reforms of their own.

**Joint-stock banks.** There are 13 joint-stock banks with sizeable national business scope, more than half of which have secured a tie-up with foreign strategic partners (see chart 5). Several more are still in negotiations with potential foreign partners. Five of the 13 are listed in the domestic stock markets. Bank of Communications, which is the largest joint-stock bank by assets, has been listed on the Hong Kong stock exchange since June 2005. This and other joint-stock banks have strengthened their capital base through injection of funds by new partners, IPOs as well as subordinated debt issues. Due to joint-stock banks’ typically fast expanding loan books, they face pressure to raise capital in order to maintain an acceptable CAR ratio of at least 8%. The central government is not taking an active role in the reform of these banks as they do with the big 4. Imperatives to reform fall largely on the joint-stock banks’ owners, which are typically state-owned enterprises (SOEs) or large Chinese corporations. The joint-stock banks with foreign partners are reported to be actively engaging the partners’ help in the design of improved risk management and internal control systems.

---

7 A prominent Hong Kong businessman.

City commercial banks. Some of the 117 city commercial banks have also started reform measures which involve recapitalisation, internal reform, tie-up with strategic investors, and IPOs. City commercial banks maintain strong links with local governments, which have also been a key source of recapitalisation. In addition, eleven city commercial banks have secured funding and strategic partnerships with foreign financial institutions (see table 6). The city commercial banks that have made more progress in reform are those located in the key cities in the east coast area and a few in the central and western areas. Those that have undergone reform measures represent around 50% of the sub-sector’s assets.

The attraction of the city commercial banks lies in their strong local network and knowledge. Typically, their main clients are SMEs, a key growth sector with higher margins provided that proper risk management is in place. Due to their strong ties with local governments, their deposits tend to come from local governments and corporations. The flipside is that they tend to have high loan concentration and related-party transactions.

As mentioned above, revamping of internal risk management and internal control procedures is largely a work in progress. But there have been some visible changes such as more public disclosure on financial information. Some of the city commercial banks are seeking to expand their business scope beyond their local license, which has put them at a disadvantage to the nationally-licensed big-4 and joint-stock banks. This would open the door for future mergers with other city commercial banks or with bigger banks with national license. Additionally, several city commercial banks are reportedly preparing to list on the domestic stock markets.

5. Rural credit co-operatives: Incipient reform

Rural credit co-operatives (RCC) provide funding to the rural sector in general (farmer co-operatives, SMEs and retail customers). RCC reform is highly sensitive and closely connected to the central government’s plan to develop the potential of the rural sector. RCC’s financial standing is typically weak, with a heavy NPL burden. There is a pressing need for RCC’s to become independent and financially viable entities of their own in order to effectively support future rural development.

Recapitalisation. The central government has injected close to RMB 170 bn (USD 21 bn) into some RCCs deemed qualified for reforms, in the form of central bank bills.

Internal structure reform. Since 2004, the central authorities have been trying to consolidate the RCC sector. Some of the rural credit co-operatives were merged to become rural commercial banks and rural co-operative banks under a new credit union shareholding structure. The goal is to consolidate the RCC sector, currently comprising some 30,000 RCCs, 11 rural commercial banks, and 48 rural co-operative banks into around 2,000 entities. Each entity is to have centralised control and operations to enhance its management’s effectiveness and overall efficiency.

Strategic partnership. Some of the reformed rural commercial banks and rural co-operative banks situated in cities with promising potential have attracted investments from foreign institutions. Australia & New Zealand Banking Group (ANZ) has bought a 19.9% stake of Shanghai Rural Bank. Other deals in the pipeline include

---

Rabobank and International Finance Corp (IFC) with United Rural Co-op Bank of Hangzhou, and American United Bank with Shaoxing County Rural Co-op Bank.  

All in all, however, reform of the RCC sector is likely to take longer than reform of the other types of commercial bank given the sheer number of the co-operatives involved, not to mention the political sensitivity of the issue.

**Postal Savings Bank, the new heavyweight**

The regulator, China Banking Regulatory Commission (CBRC), approved the setting up of the Postal Savings Bank in (PSB) in June 2006. The PSB is supposed to be operational in 6 months from the time of approval, which should be around end-2006.

The PSB is expected to become a key player in the financial landscape of the rural sector. It has evolved from China Post's postal services, which provides national postal service and operates the postal savings system by receiving deposits from the public. The deposits collected by China Post are in turn re-deposited with the People's Bank of China (PBC) or invested in bonds. As in many other countries, historically, the national postal savings system was created to mobilise household savings. The postal savings system’s primary role has been to accept deposits, not to lend. However, it has been experimenting in small-scale lending in selected rural areas, using deposits as collateral. The new Postal Savings Bank is likely to be majority-controlled by the State Post Bureau under a shareholding structure, and will be subject to supervision of the CBRC.

The PSB is poised to become the 5th largest commercial bank of China, with a share of around 4-5% of the banking sector’s total deposits. Since it has been providing remittances services, it enjoys the rural population’s trust. The PSB is also likely to provide retail lending to individuals in the rural areas. Overall, the PSB is expected to supplement the rural credit co-op sector and to become a significant vehicle in the provision of retail credit in the rural sector.

**6. Bank capitalisation: More needs to be done**

Gauging the actual capital adequacy situation of China’s banking sector is difficult as there are no official public data on the subject (see chart 7 for CAR ratio of other key Asian banking sectors). Undoubtedly, the capital raising exercises mentioned above have generally helped improve capital adequacy at most of the large banks such as three of the big 4, leading joint-stock banks and city commercial banks. However, there are many other banks that have not made similar progress.

According to the CBRC, 53 banks, which account for 75% of total banking sector assets, met the 8% minimum CAR requirement at end-2005. However, not all of these banks have met PBC’s requirements on provisioning for bad assets yet. For example, city commercial banks are only required to meet full provisioning requirements for bad assets by 2008. Thus, if full provisioning requirements were applied today, the CAR of many banks would be lower than the minimum 8%. The ratio of loan-loss reserves (LLR) to non-performing assets (NPA) in China is low compared with non-Japan Asia’s peers (see chart 8). The average LLR/NPA ratio is at

---

10 Ibid.
least 40% in most Asian banking systems, the exceptions being China and Taiwan.11

Among Chinese banks, LLR coverage varies. It is higher among listed national banks (above 70% on average). For most other types of banks, the LLR ratio is below 40%. A number of domestic banks still have LLR coverage even below 20%. Low loan-loss reserves may be evidence that a great number of Chinese banks are still capital-hungry.

7. Bank credit expanding rapidly, consumer loans gain in importance

Financial institutions’ credit growth remains high and has actually accelerated. It reached above 15% yoy in September 2006, up from 13% at end-2005 (see chart), despite various efforts by the authorities to slow lending activities. Strong loan growth to overheating sectors remains a key concern to the authorities. PBC instituted two interest rate hikes in four months this year, as well as a hike in reserve requirements and tightening measures for lending for property purchases. The government’s bias to slow down especially long-term loans was evident in the interest rate hikes in August 2006, when interest rates for longer-term lending were raised more strongly than 1-year lending rates.12 This reflects the authorities’ growing concern over a possible mismatch between long-term lending and short-term funding, given that demand-deposit growth has been picking up while time-deposit growth is moderating (see chart). Overall, despite strong loan growth, liquidity is not a problem. In fact, the loan/deposit ratio has been falling from 77% at the beginning of 2004 to around 67% currently, due to even stronger deposit growth (see chart).

One of the recent noteworthy trends was the increase in importance of consumer loans in overall bank lending. The share of consumer loans in total loans rose from 6% in 2000 to almost 11% in 2005. Individual mortgage loans make up around 84% of total consumer loans. The growth rate of consumer loans has moderated in recent years, due not least to the authorities’ attempts to cool down property speculation. Nevertheless, consumer loans still increased by 10% yoy, and mortgage loans by 16% yoy in 2005. Consumer loans are likely to become a growth area for Chinese banks. In comparison with corporate loans they present better asset quality and usually higher risk-adjusted returns, as well as a more stable stream of revenues.

8. Regulatory capability and quality have improved substantially

Better reporting/monitoring systems and more focus on prudential regulations

One of the more visible improvements in China’s banking sector over the past few years has been the improving regulatory capability and quality. Considering that the China Banking Regulatory Commission (CBRC), the banking sector’s key regulator, was only set up in 2003, it has made tremendous progress. The CBRC has been successful in encouraging almost all Chinese banks to adopt a 5-category loan classification system (as opposed to the previous payment-overdue system). The CBRC has stepped up banks’

---

11 Standard & Poor’s Asia Pacific Banking Outlook 2006, January 2006.
12 The lending rates hike of August 2006 was: 27 bp hike for 1-year lending rate, 36 bp hike for 3-5 year loans, 45 bp hike for over 5-year loans.
China’s banking sector: Ripe for the next stage?

December 7, 2006

reporting requirements with special focus on timely monitoring of asset quality. It has also set up an early alert on large-client exposure and loan concentration. The CBRC has introduced guidelines on assigning supervisory ratings for commercial banks, based on a CAMEL model\(^\text{13}\).

In addition to the traditional on-site examinations, the CBRC has widened its role to include promoting prudential regulation. This is indeed a welcome trend given the changing nature of banking, where risk controlling is no longer a mere monitoring of financial ratios. The CBRC has been issuing guidelines and regulations on corporate governance and internal controls to ensure that proper and adequate risk management is in place, a move toward qualitative and preventive risk monitoring. Nevertheless, on-site inspections remain crucial. In this regard, the CBRC faces challenges in terms of staff sufficiency and training.

**Improving financial disclosure and credit information**

The CBRC now publishes quarterly information on NPL ratios, NPL disposal by the state asset management companies (AMCs), and total assets and liabilities of banks. This promotes financial disclosure among individual banks, and greatly enhances confidence among investors who are interested in investing in Chinese banks.

In addition, a national database on consumer credit came into operation at the beginning of 2006, providing records on borrowing history including mortgage and credit card information. The database is comprehensive and covers almost all outstanding consumer credits. There is a plan to set up a similar database for corporate borrowers, but it has yet to become fully operational. The database will be managed by the PBC.

**Official deposit insurance scheme yet to materialise**

Currently, China does not have an official deposit insurance scheme. However, there is an implicit deposit insurance scheme for small depositors. A joint document by the PBC, CBRC, Ministry of Finance (MOF) and China Securities Regulatory Commission (CSRC) issued in 2004, “Directive on Paying Retail Liabilities and Client's Funds in Security Transactions” states that the government guarantees 100% for amounts of up to RMB 100,000 in individual banks accounts. The guarantee covers only “natural” persons, but not legal entities i.e. corporates.\(^\text{14}\) There is an ongoing debate among the key public agencies on the set-up of an official deposit insurance scheme in order to enhance public confidence in the system and create a damage-control procedure in case a bank faces liquidity distress.

---

\(^{13}\) Internationally recognised rating system to assess financial condition and overall soundness of a financial institution. CAMEL = Capital Adequacy, Management, Earnings, and Liquidity.

II. China’s Banking Sector: Outlook

1. Consumer and private-enterprise lending are new growth areas

As the authorities are pushing ahead at a fast pace to deepen and widen capital markets, both equities and bonds, it is foreseeable that banks will face stiffer competition for corporate lending. The experience of developed economies provides a glimpse of things to come. Corporate bonds and stock markets are usually the preferred avenue of funding for large corporates and infrastructure projects. Currently, some of China’s cash-rich SOEs are already funding their investments partially with their cash surplus. In the future, bank lending will shift more toward consumers and the SME sector. The trend indicates that banks need to build up the capacity to deal with these new borrower segments, in particular concerning the areas of credit assessment, risk management, and marketing.

Consumer lending is already a strong growth business for Chinese Banks and the prospects are extremely bright, due to rapidly increasing incomes and the emergence of a middle class. China’s per-capita GDP has risen from USD 600 at end-1995 to USD 1,700 at end-2005, implying an increase in real terms of 11% p.a. (see chart). Considering the urban population only, the rise is even more staggering.15 DB Research’s long-term growth model, Formel-G, sees China among the star performers in terms of GDP growth into the year 2020 (see chart 14), boding well for rapidly increasing purchasing power. While the need to bridge the rural-urban gap is still very much present, there is solid evidence that income has improved largely across the board. According to the China Human Development Report 2005, the poor population in rural areas has dropped from 250 million to 26.1 million in less than three decades. In addition, monthly income in rural provinces has also risen along with urban areas. During 2001-2005, income in the poorest region rose 54% vs. the national average of 51% and Shanghai’s 32%.

As regards bank products, a growing middle class with increasing affluence bodes well for the credit card business as well as wealth management. According to Moody’s, the credit card business in China has been growing exponentially. In 2005 total bank cards in circulation reached 960 million, of which 40 million were credit cards16.

In addition to consumer loans, lending to private sector enterprises is another attractive growth area. The changing mix of China’s GDP already signals the need for a change in lending strategy by Chinese banks. According to McKinsey Global Institute research17, SOEs (both wholly-owned and partially-owned) still absorb most of the funding from the banking sector. Wholly-owned SOE accounted for 35% of bank credit and essentially all the equity and bond issues, while contributing barely a quarter of GDP. Partially-owned SOE and collective enterprises, which account for another 25% of GDP, received another 38% of bank credit. This only left 27% of bank credit to private enterprises, despite them being the new engine of growth for China’s economy, accounting for around half of GDP.

15 Due to the use of different sources, the underlying income-per-capita data in charts 12 and 13 are not comparable.
2. **Strengthening the credit culture and internal support system is crucial for banks’ future success**

Due to the change in client mix from SOEs, which enjoy implicit state support, toward consumers and private enterprises, there is an urgent need to strengthen the credit culture among both banks’ officials and customers. The days of lending based on relationship and connections are numbered. Furthermore, in an increasingly market-oriented environment, banks need more sophisticated risk management in order to factor in market risks in addition to credit risks.

Change of ownership structure, capital injections and stock market listing alone are not enough to make the banking sector reform a success. These only mark an important first step, so far impressively executed. The future success will depend on the banks’ ability to price credit, introduce product innovation, and raise the quality of service to their customers.

Moreover, in the current economic environment where real GDP has been growing at 10% yoy or above for the past few years, banks’ ability to deal with a downturn is yet untested. An IMF study on a segment of Chinese banks published in March 2006 finds that “pricing of credit risks remains undifferentiated and banks do not appear to take enterprise profitability into account when making lending decisions” 18. The observation suggests that Chinese banks’ internal reform remains a work in progress.

To be sure, the burden falls not only on banks but also on the authorities and the corporate sector. While an independent credit policy and better internal governance are tasks facing banks, the promotion of the credit culture also requires the authorities to strengthen creditors’ rights, in particular, bankruptcy and foreclosure laws. The ongoing corporate sector reform, oriented towards fostering private ownership and a more commercially-oriented business culture, is equally important. In sum, the success of China’s banking sector reform hinges upon concurrent legal and corporate sector reforms. One will not succeed without the other.

3. **Banks’ exposure to property lending will remain large in the foreseeable future**

It is difficult to gauge the exact exposure of Chinese banking sector to the real estate sector as there are no official, regularly published data series on this issue. What can be established is that the PBC closely monitors the situation, which suggests that the exposure must be considerable. The most recent specific official comment on real estate loans was made in the PBC’s China Monetary Policy Report of Q3 2005. At end-September 2005, commercial real estate loans amounted to RMB 2.68 trillion and individual housing mortgage loans amounted to RMB 1.8 trillion, making the banking sector’s exposure to the real estate sector equal to RMB 4.48 trillion or roughly 23.5% of total loans. While the authorities have apparently been concerned with the continued rise in real estate prices in certain cities (see chart), leading them to tighten rules on mortgage and real estate lending, they have also strived to maintain a balance by calling for banks to “reasonably support real estate development projects that are in conformity with the policy orientation of the government” 19. The PBC has also called for efforts to promote

---


construction and purchase of low-price ordinary housing, as well as home ownership.

Commercial properties are also expanding fast as the current capacities in several key cities are deemed insufficient after several years of strong growth and the current pace of corporate expansion plans by both domestic and foreign firms.

All in all then, banks’ real estate exposure will likely remain substantial. While there is strong, genuine demand from both residential and commercial projects, the authorities’ cautionary measures to stem speculation in the real estate market seem warranted, especially in light of a possible economic slowdown in 2007.

4. More consolidation ahead in the banking sector

Further consolidation in China’s banking sector is likely in the foreseeable future, especially among joint-stock banks, city commercial banks as well as rural banks/rural credit co-operatives (RCC). The big-4 banks will be more stable in that regard since they are likely to concentrate on improving their internal efficiency rather than on acquisitions. Joint-stock banks, city commercial banks, and rural banks/RCC, in contrast, will gain from synergies through mergers and acquisitions. For example, joint-stock banks may have stronger financials, but they lack a national or regional footprint and thus may gain from a tie-up with either a city commercial bank or rural bank/RCC. The WTO liberalisation measures from December 2006 may accelerate the consolidation trend as the competitive landscape will change. A strong financial position, adequate size as well as networks with clients will now matter more. More consolidation should be positive for the banking sector as a whole.

Restructuring plans are also said to be considered regarding policy banks. There are three policy banks i.e. China Development Bank (infrastructure financing), Export-Import bank of China (export and import financing), and Agricultural Development Bank (strategic reserves and agricultural products financing). The key question is whether or not these banks should start to run on a commercial basis or continue to serve primarily the policy lending roles, which may entail losses and more state support in the future. For now the consensus that emerges appears to be to keep the policy banks wholly-owned by the government. Given the current priorities to expand infrastructure developments and social services to the far-flung provinces as well as to improve the livelihood of the rural population, the time does not seem ripe for the central government to transform policy banks into a joint stock structure as they have done with 3 of the big four.

5. Government financial support will remain crucial

In the foreseeable future, financial assistance from the central government to the banking sector will remain crucial. The capital injection into three of the big-four banks, which marked the first step in their restructuring plan, is a case in point. Large capital injections to restructure the remaining of the big four banks, ABC, as well as the rural banks and RCCs appear likely.

In addition, as mentioned in the previous sections, the need for banks to raise capital will continue to be sizeable due to their low capital-adequacy ratios and insufficient loan-loss provisions.

Last but not least, the banking sector’s large NPL legacy is yet to be disposed of. By official account, non-performing loans as of June...
China’s banking sector: Ripe for the next stage?

December 7, 2006

2006 stood at RMB 1.3 trillion (USD 162.4 bn) or around 6% of GDP. The NPL ratio has more than halved in the last two years, falling from 16.6% in March 2004 to 7.5% on June 2006 (see chart 16), facilitated to a great extent by the authorities’ capital injection into the three state-owned banks.

Meanwhile, the four state asset management companies (AMCs) had a combined accumulated disposal ratio (accumulated disposal/total NPAs purchased) of 68.6% as of Q1 2006. The accumulated disposal reached RMB 866.3 bn, out of around RMB 1.4 trillion in non-performing assets acquired in 1999. Approximately more than RMB 530 bn in NPAs on the 4 asset management companies’ books still need to be disposed of. The asset recovery ratio has not been spectacular at 24.2% (cash recovery ratio at 20.8%).

All in all, the remaining non-performing assets in the banking sector and AMCs amount to 10% of GDP, a substantial contingent liability on the state. The IMF’s estimate based on China’s official data puts the stock of NPLs at 25% of GDP at end-2005. Furthermore, in the IMF’s debt sustainability analysis, it is assumed that 16% of new loans will eventually become non-performing in the future. Thus public sector debt is estimated to rise to 40% during 2007-2011 from 38% in 2006. It is thus crucial that SOE and corporate reform be carried out to help contain new NPLs, and that simultaneously banks’ risk management capability and procedures be strengthened.

In this regard, the wider reform of the corporate sector, tax, and related legal framework cannot be neglected. It is as important as the banking sector reform itself.

6. WTO accession: No big bang for banks

According to WTO requirements, from December 2006 foreign banks will be able to offer all types of RMB businesses to all types of customers in China. There will no longer be geographical restrictions for foreign banks. In other words, the key restrictions which have so far prevented foreign banks from competing directly with Chinese banks will be lifted in December 2006. But when this happens, Chinese banks are unlikely to see an exodus of customers abandoning them for foreign banks. This is due to their extensive branch network and existing relationship with local clients. Moreover, liberalisation measures have been implemented in gradual steps since 2002, and Chinese banks have continued to expand their business successfully. Lacking in branch network, foreign banks are at a disadvantage, especially in consumer banking. A key obstacle is the slow process of branch expansion. But this may be set to improve as the CBRC will ease foreign banks applications for geographic expansion and new licenses under a new banking regulation announced on November 15. This regulation allows foreign banks to incorporate their business locally and is considered a timely move ahead of the critical December 11 date when WTO opening measures become effective. Foreign banks hold only around 2% of total banking sector assets, and their business tends to be concentrated in the big coastal cities such as Shanghai.

Despite the lifting of key restrictions on business lines, foreign banks are expected to remain focused on current business areas such as

---

20 Xinda, Huarong, Great Wall, and Orient.
21 IMF’s People’s Republic of China: 2006 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion, IMF Country Report No. 06/394
22 Moody’s estimates that around 55% of foreign bank assets are in Shanghai. Moody’s Banking System Outlook 2006: China, July 2006.
loan syndication for large projects, investment banking, treasury products, and wealth management.

Penetrating the consumer banking market and the higher-margin SME sector will require more local networks and know-how. In this regard, the model of strategic partnership between foreign banks and Chinese banks is a logical step. Partnership provides a win-win solution. While foreign banks gain distribution channels and wider customer networks, Chinese banks improve on credit and risk management, internal controls, product innovation and IT systems.

We also expect more co-operation between foreign banks and Chinese banks in investment banking/corporate finance activities, which will help supplement the revenue stream for both.

All in all, the liberalisation process in the framework of WTO accession has been successful in expediting the reform in China's banking sector. Chinese banks have not been waiting idly for competition to increase – the major ones appear already well-prepared to take on the new challenges.

Syetarn Hansakul (+65 6423-8057, syetarn.hansakul@db.com)
Global champions in waiting
Perspectives on China’s overseas direct investment ............................................................... August 4, 2006

China’s commodity hunger
Implications for Africa and Latin America ............................................................................. June 13, 2006

Environmental sector China
From major building site to growth market .............................................................................. February 28, 2006

China’s pension system
Caught between mounting legacies and unfavourable demographics ................................ February 11, 2006

Chemical industry in China:
Overtaking the competition .................................................................................................... October 25, 2005

Foreign direct investment in China –
good prospects for German companies? .......................................................................... August 24, 2004

Steel market in China:
Constraints check more powerful growth ........................................................................... August 6, 2004

Enterprise reform & stock market
development in mainland China ..................................................................................... March 25, 2004

China’s financial sector:
Institutional framework and main challenges ........................................................................ January 9, 2004