The Banking System of the People's Republic of China

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Executive Summary

Substantial progress has been made in reforming the banking sector in the People's Republic of China (PRC) during the last several years. The independence of the central bank in implementing a monetary policy has increased, the autonomy of State-owned banks in credit management has been enhanced, bank supervision has been improved, and deregulation of the foreign exchange control over current account transactions has been successfully achieved.

But the Chinese banking sector still faces formidable challenges. It is suffering from the legacy of the origin of the banks as fiscal agents for domestic resource allocation. After years of directed lending under the credit plan and administered interest rates, the State-owned commercial banks have accumulated large nonperforming loans (NPLs) and are considered insolvent. The internal organization structures, reporting channels, and information flows that were created for the convenience of government agencies; and the measures for implementing a central plan are now very inadequate for managing risk, enhancing efficiency, and maximizing profit. The banking sector is still heavily repressed by the State interventions in allocating credit to priority sectors, extensive control of interest rates, and heavy taxation. Despite recent efforts to strengthen banking supervision, progress has been limited. Many new regulations and plans have been announced, but it is not clear how effectively they are enforced. In part, this is due to the significant gap between the actual bank situation and the stipulated prudential norms. Unless the banking sector is rehabilitated and State-owned enterprises (SOEs) are restructured, strengthening the prudential regulations will remain only on paper. The authorities abandoned the credit plan in 1998, but effective instruments for indirect monetary control have not yet been put in place.

Without successfully dealing with these problems, the Chinese banks would not be able to operate as efficient financial intermediaries. The current status of the Chinese banking system constrains the development of the real sector, and even poses the potential risk of a financial crisis. The nonperforming assets problem in the PRC is huge in terms of size and very complex in terms of dimension. It is closely linked with loss-incurring SOEs. Thus, bank rehabilitation in the PRC has to be pursued in conjunction with extensive reforms in the SOEs. Otherwise, the banking sector problem will be recurrent.

Since the SOEs' financial situation is fast deteriorating, the authorities should take the restructuring of the SOEs and resolving the problem of NPLs of banks as urgent matter. This is not a task that can be accomplished overnight, but it is crucial to the process of transforming the socialist economic system into a fully market-based economy. Unless the situation is successfully dealt with, the Chinese banking sector cannot function efficiently, the Chinese economy cannot be fully integrated into the global economy, and as a result, the PRC's role in the world economy will remain limited.

To address these problems, the Chinese authorities should establish a decisive and comprehensive banking sector reform program. That program, among other things, should include detailed strategies on the following issues.

Reducing the large nonperforming assets. First, a careful and rigorous appraisal of the quality of bank assets in relation to the financial situation of SOEs must be made. An accurate appraisal of the financial viability of the major SOEs should give a realistic picture of the nonperforming assets of the banks and place the authorities in a position to decide on the exit of or the scope for restructuring the SOEs. Since the PRC does not have much expertise in this area, the authorities will need the help of internationally recognized accounting firms. Second, the Government should mobilize sufficient fiscal resources to support bank efforts in reducing their nonperforming assets and establish an explicit time schedule for the recapitalization of banks to increase their capital adequacy ratio. Third, asset management companies should be established to take over the bad assets from banks, and manage and resell them. Finally, recapitalization should be made along with improvement of the banks' management and operational efficiency as discussed below.

Minimizing the internal constraints. First, the banks need extensive reorganization. Most lending is done at the county or below-county level, and the head office has little control on the loan decisions. The structure and the corresponding reporting channels open the door to intervention by the local government. It is necessary to reorganize the banks in such a way that head office control over major loan decisions in the local branches is strengthened. Second, an extensive bank staff training program with a regular training body and adequate commercial banking curriculum should be developed. Chinese banks face serious human resource challenges. The workforce has a very limited understanding of commercial banking. Third, strategic planning is needed for the rationalization of a branch network based on adequate internal and external analyses of the market share of branches, strengths and weaknesses, current and projected profitability, business mix, and distribution mix.

Enhancing the commercial orientation of State-owned banks. First, the governance mechanism needs changes. The authorities may consider establishing a board of directors with more than half of the members being non-standing directors who are selected from the private sector for their expertise in the banking sector and professional integrity. The committee composed of these outside members should be given the right to select the bank president and to closely monitor the bank management. Second, the decision to abolish the powers that allow provincial governors and mayors to give orders to local bank managers should be strictly implemented. Third, foreign banks may be allowed to expand their domestic currency business by easing geographic and other constraints so as to permit more competition and transmission of advanced banking skills. Fourth, the high business tax imposed on the gross income from interest and fees must be reduced to help the banks regain profitability. Fifth, the authorities may allow greater flexibility in setting lending rates based on the risk represented by the borrowers.

Strengthening bank supervision. In conjunction with the rehabilitation of banks, which will reduce the gap between the stipulated prudential regulation and the actual banks' situation, the authorities should enforce the rules more strictly. First, the provisioning practice should be improved. Currently, very little provisions (far less than 1 percent) are made despite the huge NPLs. Second, loan classification should be strengthened to conform with international standards. Despite the new loan classification rule to be introduced following the US norms, the Chinese rule is still too lax and vague. Furthermore, the supervisory staff should be given training in understanding the risk characteristics of the loan portfolio. Third, the frequency of on-site inspections must be increased, mostly at provincial, city, and even county levels. In this connection, the People's Bank of China's (PBC) capacity for banking supervision has to be strengthened. Fourth, the authorities may consider introducing a deposit insurance scheme for deposit taking in nonbank financial institutions (NBFIs) on a limited scale, perhaps as a self-managed scheme by the association of each type of NBFI. For a banking sector dominated by State-owned banks, the risk of a bank run is very small and an explicit deposit insurance scheme may not be necessary at this moment. Furthermore, adequate pricing of the premium at this moment, i.e., when nonperforming assets are large, will be difficult.

To improve bank autonomy in financial management, a shift toward indirect monetary control is necessary. But the PBC should be able to use effective indirect monetary control measures to maintain macroeconomic stability. First, the monetary authorities will need to permit greater flexibility in interest rates in the money market and at the shorter end of the maturity spectrum to prepare for open market operations. Second, both the banks' required (plus guided) reserve deposit at the PBC and the PBC's credit to the banks should be reduced to broaden the room for effective monetary control.

Indirect monetary control. Until reasonable progress is made in the cited areas, the Chinese authorities should be cautious in fully opening its banking sector to the business of international lending and borrowings. Since its risk is high, the Chinese economy may have to rely on foreign direct investment as a main source of foreign capital inflow for a while. In the meantime, foreign banks need to be allowed to expand their local currency business, and to participate in the ownership of domestic banks by taking over the shares of existing banks or establishing new banks or subsidiaries.

Overview

The banking system of the People's Republic of China (PRC) is currently in transition in many respects. First, it has been going through institutional changes. Four special State-owned banks have been converted into commercial banks, and three policy-based banks have been established (1994). The State-owned commercial banks, although still heavily regulated by the Government, are gradually becoming more commercially oriented. There has also been institutional diversification with a rapid growth in the number and size of nonbanking financial institutions (NBFIs). Second, the independence of the central bank in implementing a monetary policy has been enhanced by the passage and implementation of the new People's Bank of China (PBC, central bank) law (1995), and monetary control has been moving from direct to indirect control. The law also ended PBC financing of the fiscal deficit. In January 1998, the PBC abandoned the credit plan applied to four State-owned commercial banks. Third, bank regulation is changing from almost exclusive emphasis on economic regulation such as checking compliance with credit plans and key financial ratios, to increasing emphasis on prudential regulation. The PBC issued a set of provisional rules (November 1997) establishing a board of supervisors to oversee the asset quality and management of State-owned commercial banks. It is also preparing to improve banks' portfolio management by adopting international loan classification standards. Recently, the PBC took a high profile in fighting against malpractices of bank staff and released a set of rules that penalize bank officials for violating regulations. Fourth, the Government relaxed foreign exchange control by adopting current account convertibility and allowed several foreign bank branches to engage in limited local currency business (1997); however, capital account transactions are still heavily restricted.

The changes being made are in the right direction. But the Chinese banking system is facing a big challenge. In many respects, legal changes have not fully permeated the actual operational level. Above all, the system has to deal with alarmingly large amounts of nonperforming assets. A rigorous estimate would indicate that Chinese banks are already operating in the negative capital base. Unless the PRC successfully addresses this problem, its banking system would not be able to function as an effective intermediary of national savings, and there is the potential risk that the country could face a financial crisis. The large nonperforming assets problem is huge in terms of size and complex in terms of dimension since it is closely linked to loss-incurring State-owned enterprises (SOEs). The country's banking sector reform therefore has to be addressed in relation to the reform of SOEs.

The PRC could safely distance itself from the Asian financial crisis owing largely to its closed banking system and a large amount of foreign exchange reserves. But the country will soon face strong pressure to introduce more competition in the banking system, especially by opening up to foreign entry and integrating itself into the international capital market. This will be especially true when the PRC joins the World Trade Organization (WTO). Given the speed of economic progress and the rapidly increasing role of the Chinese economy in the global economy, the opening of the Chinese banking sector and capital market cannot be postponed for long. The global economy would not remain patient in letting the Chinese financial system stay closed while its real sector and trade volume are expanding rapidly; nor would it be good for the Chinese economy to continue insulating its financial system from the global financial market.

But for the PRC to open its capital market and integrate its banking sector into the global market without destabilizing the country's financial system, many difficult problems have to be addressed in advance. The first issue is the huge nonperforming assets of the banking system. The banking sector's nonperforming assets must be reduced, the banks have to be recapitalized, and SOEs should be restructured to prevent further deterioration of the quality of bank assets. The second issue is to improve the operational and management efficiency of the financial institutions by improving the commercial orientation of banks. The third issue is to strengthen bank supervision by enforcing a tight loan classification, loan-loss provisioning, and on-site and off-site inspections. Finally, effective indirect monetary instruments have to be developed. Admittedly the tasks are not easy. Carrying out these tasks may require many years and tremendous efforts by the Government and the people. They have to face questions about the viability of the current economic system and institutions. This is one of the reasons why banking sector reform, especially the resolution of the nonperforming assets, has been postponed so far, lagging behind reforms in the trade and the real sector. Currently, the monetary authority can relax direct credit control of commercial banks without worrying much about loss of monetary control since the demand for credit is weak due to slow economic activities. But by the time the economy recovers, the monetary authority will have to be equipped with effective indirect monetary control instruments to prevent a return to the old ways of direct credit control.

Since 1994, the operations of commercial banks have been marked by increasing autonomy, more freedom from obligations to make policy loans, and a strengthened legal framework. But the operation of the Chinese banking system still needs to become much more commercially oriented. This requires not only moving toward indirect monetary control but also reducing State interventions in credit allocation. The institutional reform of distributing the policy-based lending to three newly established policy lending banks has been a significant step toward "commercialization" of the State commercial banks. But their operation needs to be more autonomous; there is also need for significant improvements in financial management, credit management, human resource deployment, accounting systems, and governance by the bank management.

The potential risk in not addressing these problems immediately is high. The many weaknesses and the sheer size of the nonperforming assets of banks have the potential to generate shocks leading to a financial crisis. Thus, the Government should establish a clear and comprehensive plan to deal with the banking sector problem soon. It should make a commitment to mobilize a sufficient amount of public funds to deal with nonperforming loans (NPL) and to recapitalize the banks. Further, it should establish a new banking environment so that bank assets quality would not quickly deteriorate again.

This paper briefly reviews the current status of the Chinese banking system and the problem it faces, and suggests improvements in the problem areas.

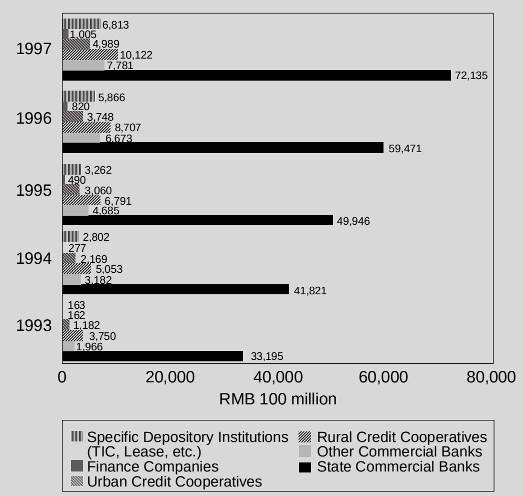
Development and Current Status of the Banking Sector

Growth of the Financial Sector

Since 1984, when its foundations were set, the new Chinese financial system has been growing rapidly and its institutional structure has diversified (Figure

1). Appendix 1 traces the institutional development of the financial sector. An array of new banks and NBFIs emerged. Bank creation occurred in three waves in 1986/87, 1992, and 1995 when 17 new banks were established.

Figure 1: Total Assets of Banks and NBFIs



Source: People's Bank of China *Quarterly Statistical Bulletin,* 1998-1.

As of 1998 the institutional structure comprised 3 policy banks; 4 large State-owned commercial banks; 14 additional commercial banks, several of which focus regionally in their deposit taking and lending activity; and a network of urban credit cooperatives, most of which have been converted into urban cooperative banks. The system is still very much under Government control exercised through the PBC, the State Planning Commission, and other agencies, and also through the ownership of most banks. Most NBFIs are also State-owned, with control usually resting in the hands of the provincial and municipal government. The banking sector dominates the financial sector, and within banking, the big four State-owned banks[1]—Industrial and Commercial Bank of China (ICBC), Construction Bank of China (CBC), Bank of China (BOC), and Agriculture Bank of China (ABC)—are the mainstay. These banks together account for over 70 percent of the total banking system assets and more than one third of the financial system assets. The big four have total assets of over $1 trillion; a workforce of 2 million; and over 160,000 branches, subbranches, and business outlets.

The big four were established/rechartered as specialized banks during the first wave of reforms in the early 1980s that focused on breaking up the monobank system. In the early 1990s, the authorities mandated that these banks be gradually transformed from their role as State fiscal agencies into commercial banking organizations. Under the Commercial Banking Law of 1995, they were reclassified as commercial banks. Policy loans were entrusted to three new policy banks— the State Development Bank of China (SDBC), the Agricultural Development Bank of China (ADBC), and the Export-Import Bank of China (EIBC)—established in 1994. Since then, the big banks have taken a number of steps to transform themselves, including the establishment of asset/liability management committees, credit committees, closure of loss-incurring branches, major investments in information technology, and staff training.

The Chinese banking sector has grown very fast during the last decade (Figure 2) under the relatively stable macroeconomic environment and the Chinese households' high propensity to save (Table 1). The volume of intermediation by the Chinese bank relative to gross domestic product (GDP) is among the highest in the world, even exceeding that of most advanced countries (Figure 3). Of course, this also reflects the relative underdevelopment of NBFIs and the securities market in the PRC.

Performance of the Banking Sector

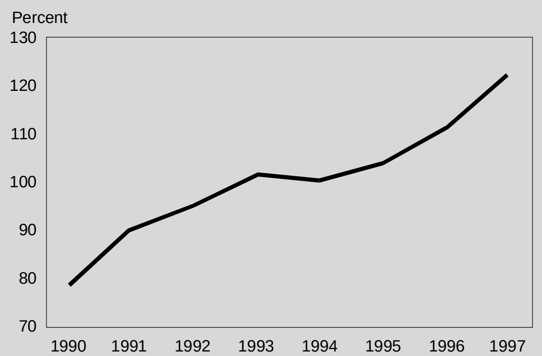
In terms of operational efficiency and asset quality, the Chinese banking system has many problems. By every available measure—capital adequacy, loan-loss reserves relative to assets, profitability, and the magnitude of NPLs—the performance and health of the PRC's financial sector have deteriorated in recent years. The deterioration is particularly clear for the largest State-owned banks, which account for more than 70 percent of the assets of the entire financial system. Even some of the newest institutions are

Table 1: Macroeconomic Indicators (percent)

Item	1990	1991	1992	1993	1994	1995	1996	1997
M2 growth	28.90	26.70	30.80	23.70	35.10	29.50	25.30	19.60
Fiscal Deficit/GDP[a]	-0.75	-0.94	-0.89	-0.58	-1.20	-1.70	-1.60	-1.60
Current Account/GDP	4.00	4.40	1.30	-2.70	1.30	0.10	0.50	2.50
Economic Growth	3.80	9.20	14.20	13.50	12.70	10.50	9.60	8.80
Domestic Savings/GDP	38.70	39.20	40.10	41.70	41.90	41.10	40.30	na
CPI[b] Inflation	2.10	2.70	5.40	13.00	24.10	17.10	8.30	2.80

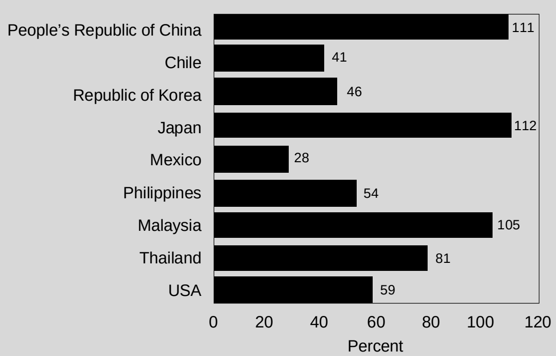
na = not available.
[a] GDP = gross domestic product.
[b] CPI = consumer price index.
Source: *International Financial Statistics Yearbook,* 1997.

Figure 2: Growth of the Banking Sector (M2/GDP)



Source: *International Financial Statistics Yearbook,* 1997.

Figure 3: The Size of the Banking Sector in Nine Countries, 1997 (M2/GDP)



Source: *International Financial Statistics Yearbook,* 1997.

extraordinarily weak, as reflected in the failure of the Hainan Development Bank in June 1998.

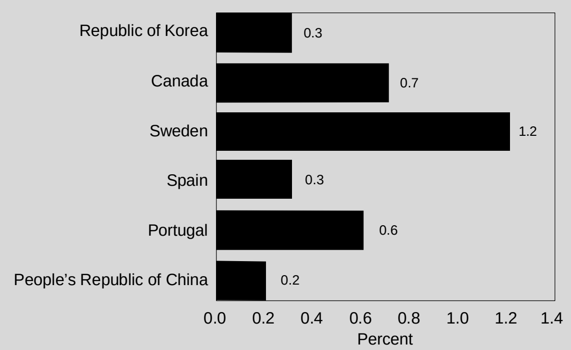
In 1985 the four largest State-owned banks had a net worth equal to 13.2 percent of their assets. By end of 1996, the net worth was equal to only 3.1 percent of the bank assets. Reserves set aside by the four banks to cover loan-loss reserves are best described as minuscule. Cumulative reserves at CBC and ABC at end of 1996, for example, were 0.58 percent and 0.47 percent, respectively, of those institutions' outstanding loans. For the largest bank, ICBC, the number is only slightly higher, 0.7 percent. Expressed as a percent of total assets, the percentage figures would be even smaller: for example, 0.3 percent in the case of ICBC. As regards the return on assets (ROA) and efficiency measure, the Chinese banks (especially the big four) are the poorest compared with banks in other countries (Figures 4, 5, and 6).

Moreover, Chinese banks vastly overstate their profits. In part this arises because of the practice of capitalizing interest payments and accruing interest on NPLs. For example, while loans are classified as "past due" as soon as any scheduled interest payment or repayment of principal has been missed, banks are required to accrue interest for two years after a loan is classified as past due. Recording accrued interest as income results in a vast overstatement of real profits. Equally common, loans are rolled over and the interest due is capitalized and recorded by the banks as income. The poor performance of Chinese banks is caused by the large amounts of nonperforming assets, low interest rate spreads, overstaffing, and operational and management inefficiencies.

Nonperforming Loans

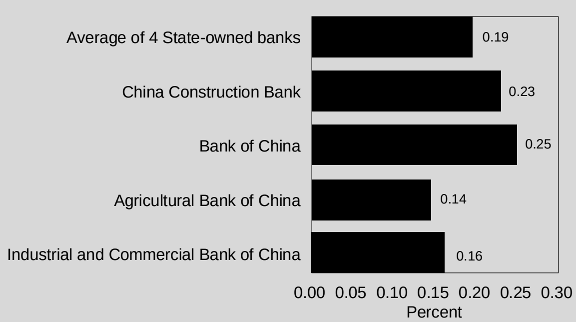
After years of directed lending under credit ceilings and administered interest rates, the four big

Figure 4: Return on Assets for Six Countries, 1996



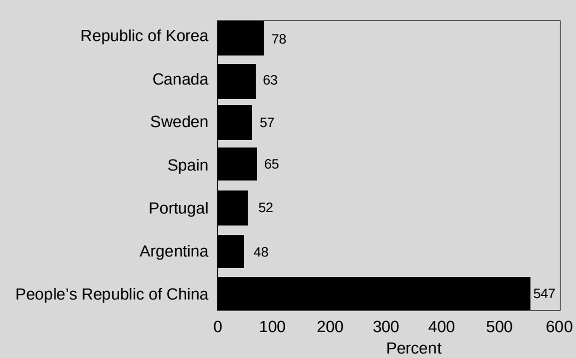
Sources: People's Bank of China, 1997 and *Almanac of China's Finance and Banking* for China*; McKinsey & Company* for other countries.

Figure 5: Return on Assets for Four State-Owned Banks, 1996



Sources: People's Bank of China, 1997; *Almanac of China's Finance and Banking.*

Figure 6: Bank Efficiency in Seven Countries, 1996



Note: Efficiency here is measured by this formula: noninterest expense/(net interest income + net non-interest income). The higher the ratio is, the lower is the efficiency. Sources: People's Bank of China, 1997 and *Almanac of China's Finance and Banking* for China, *McKinsey & Company* for other countries.

banks are confronted with a large proportion of NPLs. The quality of the loan portfolios of the Chinese banks has deteriorated in the 1990s. NPLs as a share of their total loans are estimated to have increased to about 25 percent at the end of 1997. When interviewed in December 1998, Mr. Dai Xianlong, Governor of PBC, stated that more than 20 percent of the PRC's State bank loans are nonperforming, with 5-6 percent of the total unrecoverable. Standard & Poor's Ratings Group estimated that by the end of 1997, NPLs accounted for 24 percent of the PRC's total outstanding loans. Some market watchers say, however, that the ratio could be as high as 40 percent.

The authorities have begun to pay increasing attention to improving bank soundness, by instructing the State commercial banks to reduce the share of NPLs in their total portfolios, increase loan-loss provisions, and shore up core capital ratios. Each year, the Ministry of Finance sets a limit on the amount of bad loans that State-owned commercial banks are allowed to write off. The limit for 1998 was RMB50 billion, with RMB40 billion earmarked for debt forgiveness for bad loans arising from SOE restructuring (primarily mergers and bankruptcy). This limit was up from RMB30 billion in 1997, and would rise to RMB60 billion in 1999 and to RMB70 billion in 2000. This will help increase the transparency of the bank financial status, decrease the tax burden of banks, and partially reduce the nonperforming assets. The recapitalization plan as announced in late February 1998 (page 48) will help the four big banks increase their CAR, but will not solve the inherited problem of bad loans. While the decision to inject additional capital may help reduce the problem temporarily, the risk is that the additional capital may turn out to be a waste of scarce resources. To avoid this risk, the Government should establish a comprehensive plan to rehabilitate the banks and implement specific measures for preventing the deterioration of bank assets quality in the future.

Internal Constraints

The organization structures, reporting channels, and information flows that were created for the convenience of government agencies and to assure implementation of the central plan are proving totally inadequate for managing risk, enhancing efficiency, and maximizing profits. The banks are organized in a hierarchical manner, have weak control/influence over their branches, have weak risk management and internal control systems, and lack appropriate governance mechanisms. The workforce needs training for better understanding of commercial banking. A number of diagnostic studies undertaken during the last two to three years reveal a large number of internal constraints to commercialization including organizational structure, financial and credit management, strategic planning, human resource development, and governance structure (pages 48, 49–50).

Interest Rate Spreads

In the PRC, the margins between deposit and lending fluctuated. On several occasions, deposit rates exceeded lending rates of similar maturity. This, with other factors, impaired the commercial banks' profitability.[2] Recently, however, interest rates were more frequently adjusted, and the margin between the lending and deposit rates was expanded. However, it decreased again in the adjustment in July 1998 (Table 2). Under the current circumstances, the interest rate margin may have to be widened for a while to help increase the banks' capital base.

Opening the Banking Sector to Foreign Competition

The history of the opening and liberalization of the Chinese economy is short, as is the history of the modern Chinese banking system. Compared with its short history, however, the development of the Chinese banking system has been impressive, in terms of both the volume of intermediation and the modes of operation. But it is still far from international standards in many respects.

The official total foreign debt of the PRC amounted to $131 billion, equivalent to about 14 percent of GDP at the end of 1997. Of this amount, the short-term debt was 14 percent (Table 3).[3]

Total foreign borrowing by the commercial banks is about $50 billion in 1996, or about 40 percent of the total foreign debt.[4] However, this is equivalent to only 5 percent of the total liability of the deposit money banks (DMBs) and about one third of DMBs borrowing from the central bank (Table 4). The Chinese banking system is relatively much less exposed to the foreign borrowing and lending business than banks in other countries.

On the other hand, the PRC's official foreign exchange reserve at the end of 1997 was $141 billion, about 8 times the short-term debt (or 217 percent of the short-term debt after adjusting the missing gap), that distinguishes the PRC from other crisis-affected countries (Table 5). This effectively bars any immediate possibility of a currency crisis in the PRC, but it also exerts less pressure on the Chinese economy to reform its banking sector.

The Chinese Government has deregulated the foreign exchange control over current account transactions. It has also partially opened up the banking sector since April 1997: foreign banks have been allowed to conduct a limited range of local currency business. So far, nine foreign banks have been permitted to conduct local currency business in Pudong, Shanghai. In May 1998, eight of the nine

Table 2: Major Interest Rates (percent)

Item	1993	1994	1995	1996	1997	1998[a]
Lending Rates[b] (A)	10.98	10.98	12.06	10.08	8.64	6.93
Deposit Rates[c] (B)	10.98	10.98	10.98	7.47	5.67	4.77
A-B	0.00	0.00	1.08	2.61	2.97	2.16

[a] As of July.
[b] 1-year working capital loans (ordinary).
[c] 1-year household savings deposits.
Source: *International Financial Statistics Yearbook*, 1997.

Table 3: **External Debts**

Item	1991	1992	1993	1994	1995	1996	1997
				$ billion			
Long-Term	50.26	58.48	70.03	82.39	94.68	102.17	112.82
Short-Term	10.30	10.85	13.55	10.42	11.91	14.11	18.14
Total	**60.56**	**69.33**	**83.58**	**92.81**	**106.59**	**116.28**	**130.96**
Foreign Exchange Reserves	21.71	19.44	21.20	51.62	73.60	105.03	140.90
				Percent of total debt			
Long-Term	83.0	84.4	83.8	88.8	88.8	87.9	86.1
Short-Term	17.0	15.6	16.2	11.2	11.2	12.1	13.9
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: People's Bank of China. 1997. *Almanac of China's Finance and Banking.*

Table 4: **Liabilities of Deposit Money Banks (percent)**

Item	1993	1994	1995	1996	1997
Liabilities to Central Bank/Total Liabilities	25.29	20.50	17.51	17.54	14.68
Foreign Liabilities/Total Liabilities	5.94	7.53	6.58	5.23	4.47

Source: People's Bank of China. 1998. *Quarterly Statistical Bulletin*, 1998-1.

Table 5: **Foreign Debt and Reserves[a] (percent)**

Item	People's Republic of China	Republic of Korea	Thailand	Indonesia	Philippines	Malaysia
Foreign Debts/GDP	14	22	46	47	54	39
Foreign Reserve/Short-Term Debt	777	55	109	73	84	284

[a] Figures are for end of 1997 for the PRC and end of 1996 for other countries.
Source: People's Bank of China. 1997. *Almanac of China's Finance and Banking.*

were allowed to enter the national interbank market. They can now participate in interbank borrowing, and bond trading and bond purchasing through a national trading and information network. Other foreign banks concentrate mainly on syndicated lending and trade finance. The Government still strictly controls foreign capital transactions. According to one foreign bank branch manager in Shanghai, although local business represents only 2 percent of that bank's total business now, it accounts for about 15 percent of its total profit. This may indicate the gap in efficiency between foreign and local banks.

The Chinese economy has grown very fast during the last 20 years and will continue to do so. Its role in the global economy has also changed significantly during the last decade. Through the Asian financial crisis, the role of the Chinese economy in the global economy will be further enhanced. These changing internal and external circumstances would not allow the Chinese banking system to remain closed for long. The fast growth of the real sector and the increasing role of the Chinese economy in the global market will lead to the faster transformation of the Chinese banking system. The pressure will come from the domestic side too, as Chinese firms become more internationalized.

But Chinese banks as yet do not seem to be ready to open fully to foreign competition. Currently their rate of return to assets is far lower than that in banks in other countries. Their capital/asset ratio, even if based on book value, is very low by international standard and deteriorating rapidly (Table 6). It is known that at least 5 or 6 percent of their total loan is already bad debt, which needs to be written off. If full provision is made for loan loss, their real capital may be negative (Table 8).

Table 6: Capital/Asset Ratio of Chinese Banks[a]

Year	Percent
1993	4.90
1994	4.64
1995	3.78
1996	3.31
1997	2.77

[a] Deposit money banks.
Source: People's Bank of China. 1998. *Quarterly Statistical Bulletin*, 1998-1.

The immediate cause of the currency crisis in East Asian countries including Indonesia, Korea, and Thailand was the banking sector problem. The increased nonperforming assets of the banking sector prompted foreign creditors to deny the revolving of short-term credit. The Chinese banking sector, which is burdened with nonperforming assets not less than those of other countries, was shielded from the crisis mainly because it was closed and, as a result, its short-term foreign debt was small. If the Chinese banking system were as open as those of, say, Korea and Thailand, and if it had been allowed to borrow freely in the international banking community to meet the avid investment demand of its domestic clients, the PRC could have faced a situation similar to that of the East Asian countries. This implies that a key to dealing effectively with nonperforming assets is to secure the stability of the banking system and reduce the risk of a currency crisis in a more open and liberal financial market environment. If the PRC fails to address the problem of nonperforming assets, its banking system will have to remain protected from the international banking business.

It may be useful to study the experience of Korea at this point. The Korean authorities protected the domestic banking system from foreign competition and used it as a tool to support industrial policy goals. However, after its economy and trade volume had grown fast, it faced increasing pressure from abroad as well as from domestic industries to accelerate the opening of the financial market. Succumbing to pressure, the authorities opened the banking business. But they did so without cleaning the NPLs, strengthening the prudential norms and regulations, and implementing reforms needed to improve the governance structure, credit management, and accounting standards. When foreign creditors noticed the substantial nonperforming assets of the banking system — which had been concealed under the poor accounting practice — and inadequate banking supervision, Korea found itself enmeshed in the financial and currency crises. This suggests that it is highly risky to fully expose the currently troubled Chinese banking system to the international financial market.

Policy Issues and Recommendations

The problems of the Chinese banking sector are a combination of the legacy of its economic system, poor management, and misguided incentive structure. As a result, it is not easy to fix these problems in isolation from other economic problems. The Government should address the banking sector problem in the context of a comprehensive economic reform strategy encompassing reforms in the SOEs. Otherwise, the banking sector reform will be only partially successful, with the risk of the same problems recurring.

With respect to reforms in the banking sector in particular, it is recommended that the Government establish a comprehensive plan covering the following areas:

- It must deal with the large nonperforming assets and poor capital/asset ratio through a rigorous reappraisal of the financial status of banks and their recapitalization.
- It must provide a more commercially oriented banking environment by (i) further reducing intervention in banks' allocation of loans to priority sectors, and (ii) allowing more autonomy in credit decisions.

- It should try to relax the internal constraints of banks, which limit the latter's efficient operation.
- It should strengthen banking supervision, and accounting and audit standards.
- It should promote the development of the money market and increase the flexibility of short-term interest rates to make more market-based monetary control possible.

Dealing with Nonperforming Assets

In the PRC, the bulk of the nonperforming assets in the banking system is linked to SOEs. Thus, dealing with NPLs becomes complicated since it has to be done in conjunction with reforms in the SOEs.[5] It appears that the financial situation of the SOEs is fast deteriorating. Data on the scale and quality of enterprise liabilities are scarce and unreliable. Given the poor quality of enterprise and bank financial records, few are adequately audited. It is therefore difficult at this stage to determine the scale of bank indebtedness due to the troubled SOEs. The PRC currently has more than 300,000 SOEs. It is estimated that the proportion of loss-incurring SOEs grew from 10 percent of the total in 1985 to 47 percent in 1997. In the first quarter of 1997, the SOE sector as a whole operated at a loss. Various studies suggest that the financial situation of the SOEs is fast getting worse, and it is highly leveraged. According to Wei and Wang (1997), "the debt-to-asset ratio of the SOEs was 60 percent in 1990 and has now reached an alarming 82 percent." The debt ratio of loss-incurring SOEs was close to 80 percent in 1995 according to an industrial census (Table 7). A national industrial census in 1995 revealed that for more than 900 major industrial products, the rate of capacity utilization was below 60 percent (Lardy 1998). For example, for photographic film the rate was 13.3 percent; movie film, 25.5 percent; color television, 46.1 percent; telephone sets, 51.4 percent; video recorders, 40.3 percent; soap, 42.2 percent; and household air conditioners, 33.5 percent. The low rates of capacity utilization were not confined to consumer products and consumer durables. Capacity utilization in cold rolled steel was 53.0 percent; refractory materials, 26.2 percent; chemical pesticides, 41.6 percent; internal combustion engines, 43.9 percent; and motor vehicles, 44.3 percent.[6]

The situation causes problems for both enterprises and banks. About 80 percent of the debts were owed to the State-owned banks (Li 1995). The main mechanism through which loss-incurring SOEs are kept afloat is generous lending made by the State-owned banks. The relations of SOEs with banks and other creditors reportedly further deteriorated in 1995–1997, as loans increasingly had to be rolled over and "triangular debts"[7] between enterprises increased.

The preceding statistics suggest that the rationalization of the Chinese banking sector cannot be achieved without relevant reforms in the SOE sector. Simply recapitalizing the banks without restructuring the SOEs and improving the environment of the banking business can mean waste of taxpayers' money. The rehabilitation of the Chinese banking system can be carried out following these steps.

Table 7: Industrial Liabilities and Asset, 1995

Item	Assets (RMB billion)	Liabilities (RMB billion)	Liability/Asset Ratio (%)
All Industrial Enterprises[a]	7,923	5,175	65.3
Profitable Enterprises	5,936	3,664	61.7
Loss-Incurring Enterprises	1,987	1,511	76.0
All Industrial SOEs	4,747	3,125	65.8
Centrally Owned	1,685	997	59.2
Locally Owned	3,062	2,128	69.5

[a] Asset levels for petroleum and textiles are nearly identical.
Source: StateStatistical Bureau. 1995. *Industrial Census.*

RIGOROUS APPRAISAL OF THE SIZE OF NONPERFORMING LOANS

The first step toward bank rehabilitation should be to make an accurate appraisal of the financial viability of the major State enterprises. Since the PRC does not have expertise in this area, the authorities may contract internationally recognized accounting firms to make a rigorous appraisal. On the basis of the appraisal, the authorities should decide on the exit of the SOEs or the scope for their restructuring. The authorities may then have a realistic picture of the NPLs of the banks, and the amount of adequate provisioning needed. As mentioned earlier, the Ministry of Finance sets limits on the amount of bad loans that State-owned commercial banks are allowed to write off. The limit for 1998 was RMB50 billion, up from RMB30 billion in 1997. This rose to RMB60 billion for 1999 and RMB70 billion for 2000 to address the currently estimated NPLs. But this amount would be far smaller than that required, considering the current level of NPLs.

MOBILIZATION OF ADEQUATE FISCAL RESOURCES

From the realistic diagnosis of the loan portfolio and adequate provisioning, the authorities will have to decide the amount of fiscal resources to be mobilized to restore the soundness of the banking system. More recently, and directly in response to the financial crisis in Southeast Asian countries, the authorities announced their intention to provide RMB270 billion as fresh capital to the four big banks in stages through issuance of special treasury bonds. The objective is eventually to reach the 8 percent capital adequacy ratio (CAR). While the decision to inject additional capital may be in response to the market's perception of the fragile financial position of the four big banks, it is not considered sufficient, nor is it being undertaken in the context of an overall framework for reforming these banks. As a result, there is the risk that the additional capital may be wasted.

Table 8 gives a rough estimate of the total fiscal resources that will be needed to rehabilitate the four big State-owned commercial banks. Currently, the capital and reserve of the four big banks are about RMB270 billion. For these banks to have 8 percent capital asset ratio, they need approximately RMB600 billion after writing off loan losses. Assuming various nonperforming assets ratio (20 percent and 30 percent) and loan-loss ratio (30 percent and 70 percent), it is estimated that around RMB1 trillion-1.8 trillion is needed to rehabilitate the four banks.

Table 8: Required Fiscal Resources to Rehabilitate the Four Big State-Owned Commercial Banks (RMB billion)

Capital and Reserves (A)	270
Total Loans[a] (B)	7,213
Total Nonperforming Loans (NPLs):	
(C) (= (B)’ 20%)	1,442
(C)’ (= (B)’ 30%)	2,163
Loan Losses:	
Assumed Loan Losses (%)	
(D) (= (C)’ 50%)	721
(D)’ (= (C)’ 50%)	1,082
(E) (= (C) × 70%)	1,010
(E)’ (= (C)’ × 70%)	1,515
(1) Capital Deficit after NPL Losses	
(F) = (A) - (D)	-451
(F)’ = (A) - (D)’	-812
(G) = (A) - (E)	-740
(G)’ = (A) - (E)’	-1,245
(2) Amount Needed to Recapitalize to 8% CAR[b]	600
Total Required Resources	
(2) - (F)	1,051
(2) - (F)’	1,412
(2) - (G)	1,340
(2) - (G)’	1,845

[a] Total loan of financial institutions in 1997. Bank of China.
[b] CAR = capital adequacy ratio. Total asset of four State-owned banks was about RMB1 trillion in 1997, and it is assumed here that 25 percent of it is risk-free asset.
Source: Author's estimates.

If we assume that the NPL ratio is 20 percent and about half of NPL is recoverable, then the total fiscal implication will be about RMB1 trillion.[8] If we assume, however, that the NPL ratio is 30 percent and only 30 percent of NPL is recoverable, then the total fiscal resources required will be about RMB1.8 trillion. These figures do not include the initial costs of the purchase of the nonperforming assets by the Government or by asset management companies. If other commercial banks and deposit-taking NBFIs are included, the total fiscal resources needed to rehabilitate all troubled financial institutions in the PRC may well go beyond RMB2 trillion, which is 25-30 percent of GDP. Most of these funds must be mobilized by issuing Government bonds.

ESTABLISHMENT OF ASSET MANAGEMENT COMPANIES

To carve out bad assets from the banks effectively, Chinese authorities will need to establish asset management companies that will purchase bad assets from the banks, manage them efficiently, and then resell them. Considering the huge size of nonperforming assets and the geographic diversification of the country, the authorities may consider the establishment of multiple companies, each dealing with a different type of assets or assets of different industries.

RECAPITALIZATION OF BANKS

Once the nonperforming assets are carved out and losses are written off, the Government can identify the amount to be supplied to recapitalize the banks to the minimum CAR of 8 percent required by the Bank for International Settlements (BIS). The recapitalization of individual banks, however, should be conditioned on their plans to improve their management, organizational structure, human resource deployment, credit analysis, risk management capacity, etc. The authorities should ask individual banks to submit a detailed and credible plan to restructure themselves and should link Government assistance to the implementation of this plan. Otherwise, the recapitalization may have to be repeated. The authorities may also consider allowing temporarily higher interest margins (page 43).

Enhancing the Commercial Orientation of Banks

Four State-owned banks account for more than 80 percent of total bank assets and two thirds of financial assets. The condition of these banks affects the health of the entire economy. Transforming these banks into genuine commercial banks is therefore essential to improve the efficiency of allocation of financial resources in the PRC.

ENHANCEMENT OF AUTONOMY

In addition to the burden of large nonperforming assets, the four banks are currently constrained by heavy State interventions in their asset/liability management. Recapitalizing these banks is necessary, but is not a sufficient condition for ensuring that they operate on commercial terms. A substantial part of investment lending is still allocated to projects selected by the State Planning Commission, and the rest is subject to considerable informal government influence, especially in the provinces. The autonomy of the State banks in their credit decisions will have to be further enhanced. A promising sign is Premier Zhu Rongji's statement in early 1998 that, under the new system, the power of provincial governors and mayors to give orders to local bank managers will be abolished. Autonomy can also be enhanced by changing the governance structure of the banks.

GOVERNANCE

There is no formal, transparent governance mechanism for State-owned banks. The banks do not have a governing body through which ownership rights are exercised, although BOC has a board of directors. There are no institutional arrangements to separate the roles of the Government as owner, regulator, tax authority, and primary borrower. This lack aggravates the potential conflicts of interest inherent in these roles.

The authorities may consider establishing a board of directors, half of whose members are independent outside directors who are respected for their expertise and integrity. The committee composed of these outside members should be given the right to select the bank president and to closely monitor the bank management. The Government, rather than directly appointing the bank managers, may appoint the bank managers following the recommendation of this committee and get into detailed contracts with the professional managers on the performance criteria and compensation. In this way, the Government may enhance the autonomy of State-owned banks and, possibly, their management efficiency.

INCREASE OF FOREIGN PARTICIPATION

A substantial increase in competition in the banking sector will induce more commercial-oriented lending decisions of the banks. In this regard, the authorities may allow foreign banks to expand their domestic currency business by easing the geographic and other constraints imposed on these banks. The authorities may also allow foreign participation in the existing banks or establishment of new foreign commercial banks to improve the governance of banks and their operational efficiency.

IMPROVEMENT OF TAXATION

The taxes on banks need to be revised. Chinese banks are currently paying extremely high taxes for two reasons. First, poor and inadequate loan-classification and loss-provisioning policies result in a big overestimate of profits on which the income tax is levied. Second, the business tax is levied on the gross income from interest and fees. The combined business and income tax is estimated to be about 75 percent of the reported income of Chinese banks (Lardy 1998). As a result, even though banks may be incurring losses (in a strict sense), they are subject to high taxes, further eroding their capital base. The situation will be corrected once proper loan classification and loan-loss provisions are made and accounting practices are improved. Nevertheless, the high business tax imposed on the gross income of interest and fees (currently above 8 percent) needs to be reduced to improve the financial status of Chinese banks in the long run.[9]

INTEREST RATE DECONTROL

Reform of the interest rate policy will also be an integral part of the process of "commercializing" the banks. The Chinese financial sector may not yet be at the stage where it can implement full liberalization of interest rates. The current status of the financial institutions as well as the real sector's financial health, and the central bank's supervision capacity make full-scale interest rate liberalization risky. But the interest rate policy needs to be more flexible than it is now. The Government has already taken steps in the right direction by reducing the number of officially determined interest rates, introducing treasury bill auctions, and adjusting interest rates more frequently in line with inflation. But the authorities should allow greater flexibility in setting lending rates. A wider interest rate margin between loans and deposits for a short period will help improve the financial performance of the banks. Once substantial progress is made in the banks' financial situation and banking supervision, the authorities may consider expanding liberalization to deposit rates.

PRIVATIZATION

Privatization of the four State-owned banks does not seem to be a realistic option because the quality of their assets is very poor and massive rehabilitation will be required before privatization. Since asset restructuring and rehabilitation will take substantial time, privatization does not seem to be on the immediate agenda. Once substantial progress has been achieved in bank and SOE restructuring, the Government may start selling its bank share in the capital market and reduce its ownership gradually.

Dealing with Internal Constraints

The major internal constraints that the Chinese banking system currently faces and on which substantial improvements are needed can be summarized as follows:

- Organizational structure. The five-layer organizational structure—head office, provincial branch, prefecture/municipal branch, county and subcounty branch, and banking offices and deposit-taking units—of the banks mirrors that of the Government. Functional units within each vertical level replicate the organizational structure of the next level and report directly upward without significant interaction horizontally or diagonally with other departments. Such segmentation has resulted in relatively isolated compartments, limitations on data quality, inefficient flow of information, confused line of authority, and the inability of managers to supervise activities within their areas of responsibility. Head offices seem to have very little control over the operations at the branch level.
- Financial management. A proper management accounting system is absent. The financial accounting system is designed to meet statistical reporting and other regulatory requirements such as credit quota, interest rate control, and capital expenditure limit. It does not follow international norms for income/expense accruals, depreciation, equity accounting, foreign exchange translation, and income recognition and loan classification. Asset quality, capital, and profitability seem grossly overstated. Misleading and fundamentally flawed information has been used by bank management to make risk control and other business decisions, and by the Government to make tax and prudential decisions.
- Strategic planning. Business plans, investment plans, and annual budgets are based on Government targets for loans, deposits, and tax payment, instead of on in-depth analysis and independent projection of economic trends, and the banks' market position and performance. It is possible that the ongoing reform initiatives such as the rationalization of a branch network are being carried out by the banks without adequate internal and external analysis of their market share, strengths and weaknesses, current and projected profitability, business mix, and distribution network, etc. which are usually developed in a strategic business plan.
- Credit management. The organization of the credit function in the four banks reflects their history. Different departments process credit transactions based on either the type/maturity of loans, or the currency in which a loan is denominated, rather than on market segment, borrower convenience, or risk characteristics. It is often difficult to aggregate total exposure to a single borrower since loans may be distributed among several departments at different levels of the banks. The banks are unable to identify desirable risk customers or bankable projects, in the absence of active portfolio management and appropriate credit standards to identify market segments and industry viability. In addition, systems that are common internationally, such as customer risk grading and collateral security, do not exist.
- Human resource development. Due to the Government's full employment policy and the rigidities in housing patterns and traditional social practices, the management of the banks has little autonomy over recruitment, retention, discipline, rewards, and rotation of staff. In the banks, the business strategies and the human resource development policies are not aligned, resulting in high-cost, low-return training initiatives.

There should be appreciable improvements in the above areas so that the four State-owned commercial banks can successfully be transformed into genuine commercial banks. The banks need overall changes in their organizational structures; products and services; and credit analysis, management accounting, and risk management systems. Most lending is done at the county or below-county level. The authority and autonomy of a branch are determined not by its business characteristics or financial position, but by its administrative rank. The structure and the corresponding reporting channels open the door for local government intervention. It is therefore necessary to reorganize the banks in such a way that the control of the head office over major loans analysis and decisions of the local branches can be strengthened. The Chinese banks face serious human resource challenges. The workforce has a very limited understanding of commercial banking and needs extensive training. Training programs so far have been biased toward formal and classroom education. An extensive training program with a permanent staff and an adequate commercial banking curriculum should be developed. Unless the banks address the internal constraints and strengthen their internal management systems and controls, the additional capital to be provided may just be wasted.

Strengthening Bank Supervision

To prevent further deterioration of the banks' assets quality, the authorities should strengthen banking supervision. In the past, banking supervision in the PRC had focused on the banks' compliance with key policy targets and ratios. But since 1994, the focus has been gradually shifting to the observance of prudential norms. Some progress has been made in a number of areas, including loan classification, definition of past-due loans, loan-loss reserve, and disclosure requirements. Measures to strengthen banking supervision have also included greater resources at the PBC for off-site inspection and the stipulation that every commercial bank establish an internal audit department.

The PBC plans to improve the banks' portfolio management by adopting international loan classification standards based on new accounting measures and a five-category risk-based grading system.[10] The system was tried in Guangdong Province in mid-1998. The new system divides loans into five categories: normal, special attention, substandard, doubtful, and loss. However, such a loan classification system requires judgment by bank staff. Expert judgment is the result of extensive training and experience acquired over time.

The PBC issued in November 1997 a set of provisional rules establishing a board of supervisors[11] to oversee the asset quality and the management of State-owned commercial banks. The major responsibilities of the board include supervising and assessing the banks' asset/liability management; protecting and developing State assets; ensuring the quality of bank loans; evaluating the performance of the banks' board of directors and bank chiefs; and advising on the appointment, removal, and sanction of bank senior officials.

To further strengthen its supervisory power, the PBC announced in January 1998 that the central banking system would be transformed into a system similar to the Federal Reserve System. In the current system, PBC branches are under the supervision of both the central PBC and the local government where they are located. Under the restructured system, regional headquarters will be formed over the next three years by combining provincial branches. This will strengthen the PBC's supervisory and regulatory authority because the banks' local branches will report to the regional headquarters of the PBC. More importantly, this will break the traditionally strong relationship between local governments and the local PBC branches. To prepare for the reorganization, the PBC has appointed senior headquarters officials (director level) to head some strategic provincial branches.

Recently, the PBC took a high profile in fighting against malpractice by bank staff by releasing a set of rules that penalize bank officials for violating regulations, such as raising interest rates without official approval, placing public funds in private accounts, loose cash management, use of bank capital for speculation in stock markets, and violation of foreign exchange control. Overall, bank supervision has been strengthened in recent years as reflected in the closure of a large number of unauthorized institutions; closure of a large number of trust and investment companies, many of which seem to have been operated in violation of central bank regulations; and the first closure of a failed bank, the Hainan Development Bank, in June 1998.

Nevertheless, banking supervision in the PRC needs further improvement. Although many new regulations and plans have been announced, it is doubtful whether they are enforced. For instance, the Commercial Bank Law, approved by the National People's Congress in May 1995 and which took effect on 1 July 1995, stipulated a number of important prudential ratios for commercial banks:

- The CAR must not be lower than 8 percent.
- The ratio of loans to deposit must not exceed 75 percent.
- The ratio of liquid assets to liquid liabilities must not be lower than 25 percent.
- Loans to a bank's largest borrower cannot exceed 10 percent of a commercial bank's total capital.[12]

These basic ratios were an important development in the Chinese system of prudential regulation. But at the time the Commercial Bank Law was passed, none of the four large State-owned banks were anywhere near compliance with the loan/deposit prudential ratio. The situation is similar with respect to concentrated lending. Although several State-owned banks are known to have unusually large loans outstanding to single borrowers, not a single Chinese bank publicly reports its loan concentration ratio.

Banks already in existence when the Commercial Bank Law was passed, but which did not meet the specified prudential ratios, were temporarily exempted. The PBC was to later specify when those banks had to comply with the new regulations. It is not clear whether or not the central bank has promulgated a specific timetable for compliance. The capital adequacy of the largest State-owned banks has plummeted since 1995. The loan/deposit ratio of the largest bank, the ICBC, has not fallen significantly in recent years and remains far higher than the prudential ratio specified in the Commercial Bank Law.[13]

It is true that the current financial situation of Chinese banks is so poor that the international prudential norm may not be strictly enforced. But in conjunction with the rehabilitation of banks, the authorities should enforce the rules more strictly to prevent further deterioration of the financial health of the banks. First, the provisioning rule should be improved. Currently very little provisions are made. Far less than 1 percent of total loans has been provisioned, despite the huge nonperforming assets. Second, loan classification should be improved. Currently, loan classification in the PRC relies on the payment basis, not on the evaluation of the risk characteristics of borrowers. The new loan classification rule, following norms in the United States (i.e., pass, special attention, substandard, doubtful, and loss) has not yet been implemented. Implementation on the operational level requires training the supervisory staff in understanding the risk analysis of loans. Third, the frequency of on-site inspections will need to be increased, mostly at provincial, city, and even county level. Currently, on-site inspection is done every three years. The PBC's capacity for banking supervision has to be improved through training of its staff.

In addition, the infrastructure for effective banking supervision has to be improved. This will require the adoption of modern accounting systems, new financial reporting methods by the banks, and a focus in financial accounts on the overall risk borne by individual financial institutions. Accounting and auditing standards need to be rigorously implemented in all banks. Weaknesses in key financial data will defeat any efforts to strengthen supervision. Since Chinese expertise in this area is scarce, the PRC should rely a lot on technical assistance from foreign institutions to make improvements in banking supervision.

The fundamental difficulties in implementing prudential bank regulations in the PRC lie not only in weakness in technical design or experience, but perhaps to a larger extent in the legacy from the large State sector. Thus, here again, the reform of SOEs is the key factor in enforcing sound prudential regulation in the banking system. Without adequately addressing the issue of SOEs, the regulation that requires banks to reduce risky loans is unlikely to be effectively implemented.

Currently, the off-balance-sheet transactions of Chinese banks are very limited because of strict regulations on these transactions by the PBC, the limited access of the banking sector to international business, and slow development of derivative markets. But over time, the off-balance-sheet transactions are expected to increase fast and the PBC must be prepared to exercise effective supervision. In the case of NBFIs, especially trust and investment companies, the off-balance-sheet transactions seem substantial through guarantees.

Since the majority of deposits are with the State-owned financial institutions, there is an implicit deposit insurance extended to most deposits in the PRC. Therefore, the need for the establishment of an explicit deposit insurance scheme does not seem to be crucial at this moment. Given the size of the nonperforming assets of the banking sector, it is hard to expect any reasonable pricing of insurance premiums even if the deposit insurance scheme is established. However, the authorities may carefully examine the potential benefit and cost of establishing a deposit insurance scheme for NBFIs, which take deposits. The scheme may help contain the systemic risk that can be transmitted from the nonbank financial sector to the banking sector, but it may also increase a pervasive moral hazard effect on the NBFIs. Unless prudential regulation and supervision on NBFIs are significantly tightened, a deposit insurance scheme may entail substantial public cost to compensate depositors since with the banks' poor asset quality, the premiums will never be sufficient. One alternative is to encourage a self-created and managed deposit insurance scheme by each type of NBFI.

Indirect Monetary Control

The monetary authority has been successful in controlling the monetary base during the past several years. This effective monetary control has taken place despite a large increase in foreign capital inflow during the period. Sterilization of foreign capital inflows was achieved through restraints in the PBC's lending to the banks and the sale of PBC bonds to financial institutions (Table 9). As a result, the share of foreign assets in the total assets of the monetary authority increased while that of domestic assets decreased (Figure 7).

The situation was helped by some institutional changes. The Budget Law passed in early 1994 stated that the budget deficit can be financed only by issuing bonds. As a result, PBC's lending to the Government was frozen at the level of end-1993.[14] PBC's lending to the four State-owned banks was also controlled reasonably well although there was a substantial increase at the end of 1996 in relation to the PBC's support to agricultural procurement. The gross PBC claims on financial institutions increased modestly. They followed the standard seasonal pattern of declining in the first half of the year, then rising in the second half mainly on account of lending for agricultural procurement. The net PBC claims on banks have been falling each year, and are now negative.

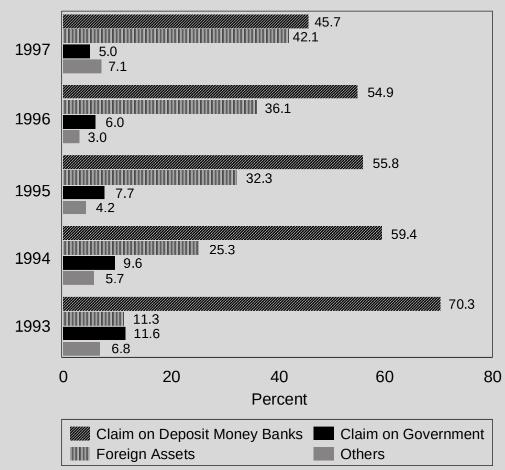
In January 1998, the PBC abandoned the credit plan, withdrawing from direct control of credit expansion. The credit plan, apart from being a key instrument for allocating resources, was the principal means by which the PBC influenced aggregate demand and controlled the money supply. But it was a relatively inflexible instrument, difficult to adjust in the face of the changing macroeconomic situation. It had also been eroded as an effective control on total bank lending because banks were giving loans in such a way as to keep them outside the credit plan. Each time the authorities issued new regulations to stem such unauthorized flows, new channels and techniques were created. Thus, abandoning the credit plan is the right step.

Table 9: Balance Sheet of the People's Bank of China (RMB billion)

Item	1993	1994	1995	1996	1997
Foreign Assets	154.95	445.13	666.95	956.22	1,322.92
Claim on Government	158.27	168.77	158.28	158.28	158.28
Claim on Deposit Money Banks	960.95	1,045.10	1,151.03	1,451.84	1,435.79
Others	93.40	99.82	86.17	80.34	224.33
Total Assets	1,367.50	1,758.82	2,062.43	2,646.68	3,141.32
Reserve Ratio[a]	22.36	21.31	21.10	22.19	21.61

[a] Required reserve plus excess reserve/Total deposit.
Source : People's Bank of China. 1998. *Quarterly Statistical Bulletin*, 1998-1, Volume IX.

Figure 7: Assets of Monetary Authorities (percent shares)



Source: People's Bank of China, *Quarterly Statistical Bulletin,* 1998-1.

However, the PBC should be able to use effective indirect monetary control instruments. Right now, the Chinese economy is slow and the demand for credit is weak. But when the macroeconomic circumstances call for a tightening of the monetary stance, there is a danger that the PBC will have to resort to old measures for direct control of credit or else loosen monetary control. The implication is that the PBC will need to quickly develop other instruments to control monetary aggregates. Certainly, the PBC is already in a position to use reserve ratios, asset/liability ratios, and the rediscount facility more actively to reduce or inject liquidity into the financial system. Over time, however, additional fine-tuning of the monetary policy will require the use of open market operations to make short-term adjustments to liquidity. For this, the monetary authority will need to permit somewhat greater flexibility of interest rates in the money market and at the shorter end of the maturity spectrum to prepare for open market operations. Without such flexibility, it would be difficult for open market operations to get off the ground. For the purpose of also increasing the autonomy of commercial banks in their asset or liability management, a shift to indirect monetary control is essential.

Currently, the PBC requires a high reserve deposit for monetary control (Table 10).[15] At the same time, it is giving a large amount of loans to commercial banks. Since the PBC's lending rate is substantially higher than the interest rate paid to reserve deposit, commercial banks are paying a substantial cost for keeping large reserve deposits. In the future, both the banks' reserve deposits and the PBC's

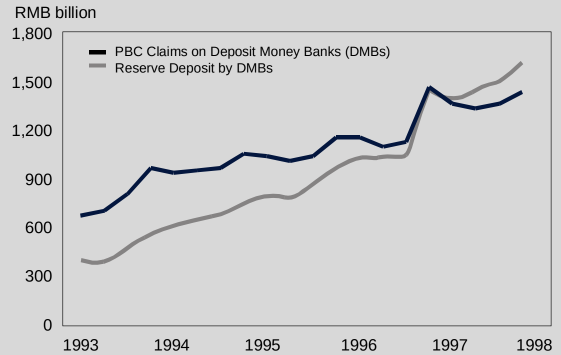
Table 10: Balance Sheet of Deposit Money Banks (percent)

Item	1993	1994	1995	1996	1997
Liabilities to Central Bank/Total Liabilities	25.29	20.50	17.51	17.54	14.68
Reserve /Total Deposit	22.36	21.08	20.69	22.19	21.61
Required Reserve/Total Deposit	11.07	11.05	10.97	10.61	12.14
Guided Excess Reserve/Total Deposit	11.29	10.03	9.72	11.58	9.47

Source: People's Bank of China. 1998. *Quarterly Statistical Bulletin*, 1998-1.

credit to banks should be reduced (i.e., the asset and liability sides of the PBC should offset each other) so as to broaden the scope for effective monetary control by the PBC. Currently, the PBC is lending RMB1,436 billion to DMBs while it takes RMB1,611 billion as a reserve deposit (Figure 8).

Figure 8: People's Bank of China (PBC) Credit vs Reserve Deposit



Source: People's Bank of China, *Quarterly Statistical Bulletin,* various issues.

In other words, the PBC is lending to banks to support their policy loans while taking large reserve deposits to offset the monetary impact—the bottom line is the squeeze on commercial bank profitability (even though interest is paid to the latter) and putting constraints on indirect monetary control. The PBC should gradually reduce both lending and reserve deposits, and in the long run should consider removing the lending for policy loans altogether from its balance sheet.

Nonbank Financial Institutions

Parallel to the development of the banking system, a range of new NBFIs emerged over the 1980s and the 1990s, becoming an important part of the financial system. NBFIs include rural credit cooperatives (about 60,000), urban credit cooperatives (about 1,500),[16] a variety of trust and investment corporations, finance companies, leasing companies, insurance companies, and securities dealers (Table 11). Most of the NBFIs are State-owned, usually with control resting in the hands of provincial and municipal governments. Many of the urban credit cooperatives have recently been merged and converted into urban cooperative banks. Many of the trust and investment corporations and most of the largest securities dealers were set up as wholly or partially owned subsidiaries of the State commercial banks.

The rapid growth in the number and size of NBFIs is one of the bright spots on the financial landscape. NBFIs contributed to the rapid expansion of the activities of the private sector whose access to the banking sector had been limited. The growth of the NBFIs is necessary to further mobilize financial savings, to develop institutional investors, and to increase the competitive force in the PRCs financial sector.

But such growth also harbors considerable risk to the banking system. The excessive growth in the number of NBFIs and their indiscriminate business operations constitute another potential threat to the stability of the financial system. By attracting deposits from local residents and paying a slightly higher interest rate than the commercial banks, rural credit cooperatives have expanded very fast. Many of them are now operating virtually as banks in that they take deposits and provide lending beyond their regional boundaries. They have contributed to the rapid development of the town and village enterprises.

There is a danger that the risky financial activities of NBFIs can transmit large systemic shocks to the banking system. The weak regulatory oversight has meant that the probability of financial failure among large NBFIs is high. At this point, the trust and investment corporations are the most troubled and need massive restructuring. Most of them have not adhered to the provisional regulations issued in 1986, which require them to have capital equivalent to at least 8 percent of their assets, to limit loans to a single enterprise to less than 30 percent of the borrower's fixed assets and less than 20 percent of the lender's capital, and to hold fixed assets at less than 30 percent of the corporation's capital. Many

Table 11: **Total Credit of Banks**

Item	1993	1994	1995	1996	1997
			RMB billion		
Banks	3,516.1	4,500.3	5,463.1	6,614.4	7,991.6
State Commercial Banks	3,319.5	4,182.1	4,994.6	5,947.1	7,213.5
Other Commercial Banks	196.6	318.2	468.5	667.3	778.1
Nonbank Financial Institutions	742.3	1,030.1	1,360.3	1,914.1	2,292.9
Rural Credit Cooperatives	375.0	505.3	679.1	870.7	1,012.2
Urban Credit Cooperatives	118.2	216.9	306.0	374.8	498.9
Finance Companies	16.3	27.7	49.0	82.0	100.5
Specific Depository Institutions[a]	232.8	280.2	326.2	586.6	681.3
Total Credit	4,258.4	5,530.4	6,823.4	8,528.5	10,284.5
			Percent of total credit		
Banks	82.6	81.4	80.1	77.6	77.7
State Commercial Banks	78.0	75.6	73.2	69.7	70.1
Other Commercial Banks	4.6	5.8	6.9	7.8	7.6
Nonbank Financial Institutions	17.4	18.6	19.9	22.4	22.3
Rural Credit Cooperatives	8.8	9.1	10.0	10.2	9.8
Urban Credit Cooperatives	2.8	3.9	4.5	4.4	4.9
Finance Companies	0.4	0.5	0.7	1.0	1.0
Specific Depository Institutions[a]	5.5	5.1	4.8	6.9	6.6

[a] Including financial trust and investment corporations, leasing companies as well as the State Development Bank of China and the Export-Import Bank of China since 1996.
Source: People's Bank of China. 1998. *Quarterly Statistical Bulletin*, 1998-1.

trust and investment companies have currently smaller assets value than liabilities and are thus insolvent. To ensure the soundness of these institutions, the authorities need to follow similar restructuring steps suggested for bank restructuring in the previous section. They should start with a rigorous appraisal of the asset quality of trust and investment companies, take steps for the closure or merger of troubled institutions, and strengthen supervision of these institutions in line with the international norms of investor protection and information disclosure.

The Government is separating NBFIs from banks to protect banks from the risks arising in the nonbank financial sector. With the same objective in mind and to tighten control over monetary aggregates, the PBC may also restrict bank lending to NBFIs through the interbank market or through other channels. While the financial failure of a large NBFI will undoubtedly have repercussions for the banking system, the effects could be dampened by introducing such firewalls between the two types of institutions.

Despite the many problems of NBFIs, the PRC may encourage their growth as a way to increase market competition and the overall efficiency of the country's financial system. Since the State-owned banks are ailing due to huge nonperforming assets the reduction of which will take substantial time, the Chinese banking system will function poorly for a while. To infuse new blood in the financial system, Chinese authorities may encourage the development of sound and efficient NBFIs. Indeed, there is merit in encouraging the entry and development of NBFIs in that they can complement the intermediation role of the ailing banks, bring about more competition in the financial system, and serve those dynamic firms that are not served well by the incumbent banks.

But there is also a risk. For instance, Korea encouraged the expansion of NBFIs when the Government found itself in a dilemma between the need for banking reforms and the difficulties of implementing them. By the early 1980s, the commercial banks were heavily loaded with NPLs as a result of the Government's strong push for heavy and chemical industry development. The Government recognized the necessity to liberalize these banks to make them more efficient allocators of fund while also using them to rehabilitate troubled industries. It chose to postpone reforms in the commercial banks, while encouraging the expansion of NBFIs as an alternative to bring more competition and market-based transactions in the financial market. As a result, NBFIs grew fast, much faster than the ailing banks, and by the early 1990s had overtaken the banks in total volume of financial intermediation. But the NBFIs also posed a tremendous moral hazard: they took advantage of the high interest rates that they could offer and charge, while shifting the ultimate default risk to the banking system. Even though a benefit was that the financial system as a whole became more commercially oriented, the banking system continued to be repressed and burdened with a large amount of nonperforming assets (Cho and Kim 1995). The NBFIs were less tightly regulated and supervised by the regulatory authorities. When Korea faced financial and banking crises, it was discovered that many NBFIs had been badly managed and had already wiped out their capital base.

The PRC also has experienced a rapid growth of NBFIs and their subsequent widespread insolvency especially for many trust and investment companies. The implication of the Korean experience is that NBFIs should be put under close prudential regulation and supervision. Although the growth of NBFIs can complement the banking sector and contribute to the efficiency of the financial system, it should not be an alternative to reforming the banking sector. In other words, banking sector reform, although a hard task to address, has to be decisively implemented for the long-term health of the Chinese economy.

Conclusions and Recommendations

Financial sector reform in the PRC has shown some significant progress. Deregulation of foreign exchange control over current account transactions has been successfully achieved, the independence of the central bank in conducting monetary policy increased, the autonomy of State-owned banks in credit management has been enhanced, and bank supervision has been improved. Nevertheless, the Chinese Government faces an immense task: rehabilitate the banking system and improve its function as an efficient financial intermediary. The Chinese banking sector is suffering from the legacy of the origin of the banks as fiscal agents of domestic resource allocation. After years of directed lending under the credit plan and administered interest rates, the State-owned commercial banks are confronted with a large proportion of NPLs and are considered insolvent. The internal organization structures, reporting channels, and information flows that were created for the convenience of government agencies and the measures for implementing a central plan are now inadequate for managing risk, enhancing efficiency, and maximizing profit.

In a sense, the PRC has done the easy part of banking and financial reforms so far, and the real challenge still lies ahead. Addressing the alarmingly large amount of NPLs, which is closely linked to loss-incurring State enterprises, and transforming the four State-owned banks into genuine commercial banks are problems that the Chinese authorities still have to resolve. It is obvious that without success in dealing with these problems the Chinese banks would not be able to operate as efficient financial intermediaries. Nor could they be safely opened to foreign competition and foreign capital transactions.

But in the PRC, the Government cannot deal with the NPLs of the State banks without resolving the problems of SOEs. Since the SOEs' financial situation has been deteriorating fast, the authorities should take the restructuring of SOEs and addressing the NPLs of banks as urgent matters. Certainly, those are not tasks that can be accomplished overnight. But unless they are successfully dealt with, the Chinese economy cannot be fully integrated into the global economy and its role in the world economy will remain limited. The current status of the Chinese banking system puts constraints on the development of the real sector and carries with it the potential risk of a financial crisis.

With respect to sequencing, the Chinese authorities should address the domestic banking sector problem with decisive and comprehensive programs before the financial system is fully opened. First, a careful and rigorous appraisal of bank assets quality in relation to the financial situation of State enterprises has to be made. Second, based on the appraisal, adequate loan-loss provisioning should be made and an explicit time schedule for recapitalization of banks to increase CARs should be established. Recapitalization should be done along with the mitigation of internal constraints. For instance, improvements have to be made in management efficiency, human resource deployment, organizational structure, governance mechanism, and credit management. Third, the overall banking environment should be improved through reduction of Government intervention in credit management, increase of competition by allowing greater foreign participation in the banking business, enhancement of management autonomy, etc. Fourth, in conjunction with improvement of the banking environment, bank supervision and prudential regulation should be strengthened. Finally, effective indirect monetary instruments must be developed.

Until reasonable progress is made in the cited areas, Chinese authorities should be cautious in opening its banking sector fully to the business of international lending and borrowings. Since its risk is high, the Chinese economy may have to rely on foreign direct investment as a main source of foreign capital inflow for a while. In the meantime, foreign banks should be allowed to expand their local currency business, and to participate in the ownership of domestic banks by taking over shares of existing banks or establishing new banks or subsidiaries. Giving foreign banks entry to the banking system will enhance competition and improve the efficiency of the system.

Notes

[1]The four big State-owned commercial banks are 100 percent owned by the central Government. All other banks, with the exception of Minsheng Bank, are jointly owned by the central and local governments and SOE conglomerates.

[2]Other factors include excessive expansion of bank branches and spiraling increases in operating costs such as salaries and bonuses and the price of rented real estate.

[3]However, there is gap between official statistics based on the balance of payments and those in the Bank for International Settlement (BIS). Such divergence between official and BIS numbers has existed in the past in the PRC as well as in other countries such as Thailand and Republic of Korea. One adjustment of about $40 billion (of which $20 billion was short-term) is for unrecorded liabilities to foreign banks. Another adjustment of about $20 billion is for short-term, trade-related debt. With these adjustments, the PRC's total external debt could be $191 billion at the end of 1997, compared with the official estimate of $131 billion. Of that, the total outstanding short-term debt could be $65 billion, compared with the official estimate of $18 billion (World Bank's informal estimates).

[4]People's Bank of China. 1998. *Quarterly Statistical Bulletin*, 1998-1.

[5]This situation is similar to the Korean case where the bulk of nonperforming assets is due to the insolvency of large corporate firms (chaebols).

[6]State Statistical Bureau, *China Statistical Yearbook 1997*, pp. 454-455.

[7]This means trade credit among firms, i.e., accounts payable and receivable.

[8]International experiences suggest that the recovery rate could be much less. Especially considering the large excess capacity and declining growth rates, nonperforming loans could further increase.

[9]The Government should find alternative tax revenue sources from other areas. Tax revenue from the banks is not one of the major sources of revenue. Thus, a reform of the tax system is also required.

[10]The current system classified nonperforming loans into three categories: (i) "overdue", or loans that have been overdue for less than two years; (ii) "idle", or loans that have been overdue for more than two years; and (iii) "bad", or loans that can be recognized as loss and are allowed to be written off.

[11]Includes representatives from the PBC, the Ministry of Finance, the State Economic and Trade Commission, the State Auditing Administration of State Property, and commercial banks, as well as economic and legal experts.

[12]*Zhonghua renmin gongheguo shangye yinghang fa (Commercial Bank Law of the People's Republic of China)*, 1995. Beijing: China Legal Publishing House, article 39.

[13]In 1996, the ratio was 0.94, not significantly different from the 0.98 prevailing in 1995 (*Almanac of China's Finance and Banking*. 1997, p.502).

[14]It temporarily increased at the end of 1994, but soon returned to the original level.

[15]Currently there are two types of reserve deposit. One is the required reserve and the other is guided excess reserve. But the PBC forces the banks to put excess reserve, through the guidance of excess reserve.

[16]See I. Islam and A. Chowdhury. 1997. *Asia-Pacific Economies: A Survey*. New York: Routledge.

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Appendix 1

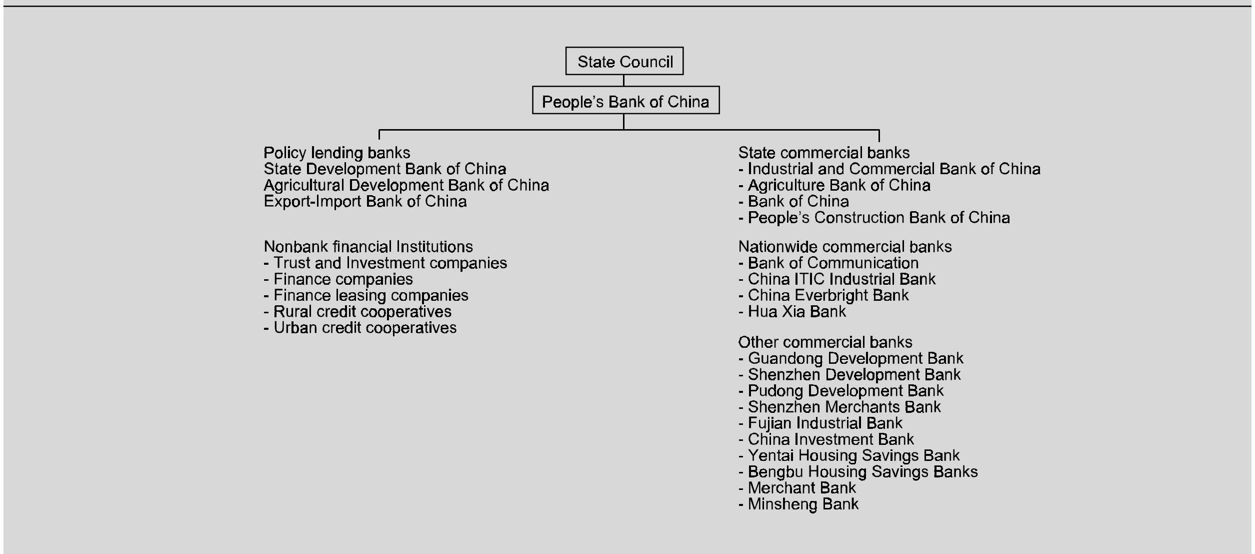
Institutional Development of the Financial Sector

The Agriculture Bank of China was reestablished as a separate financial institution in 1979; in March 1979 the Bank of China was separated from the People's Bank; and in October 1979 the Construction Bank was separated from the Ministry of Finance and also made into an independent financial institution.[1] Even more importantly, in 1983 the State Council approved the creation of a separate central bank. Institutionally this was accomplished by simply designating the People's Bank as the central bank and establishing the Industrial and Commercial Bank to take over the deposit taking, lending, and other banking functions of the People's Bank. In recent years, growth in the number and type of financial institutions has resumed as the authorities sought to gradually increase the commercial orientation of the financial sector. Laws on central and commercial banking were enacted and three policy banks[2] were established in 1994 to take up the policy-directed lending activities[3] of specialized banks, which were redesigned as "state commercial banks." Two nationwide commercial banks were licensed, along with six other commercial banks of regional significance and two "housing savings banks." In addition, some of the urban credit cooperatives (UCCs) and rural credit cooperatives (RCCs) were merged and consolidated into city and rural united banks, respectively.

The growth in the number of nonbank financial institutions slowed down in recent years, however, as the authorities have sought to separate banking and nonbanking business and banks have been required to divest themselves of their nonbank subsidiaries.[4]

At present, the financial intermediaries include the 4 state commercial banks, the policy banks, 4 nationwide banks, several other commercial banks, around 60,000 RCCs and 1,500 UCCs, trust and investment companies, finance companies, securities firms, insurance companies, and leasing companies.

Overview of China's Financial Sector



[1]The Agricultural Bank had been a separate institution in two brief periods in the 1950s and again in 1963–1965. At other times, it operated as the Rural Bank Management Bureau of the People's Bank.

[2]The policy banks are the State Development Bank of China (SDBC), the Export-Import Bank of China (EIBC), and the Agricultural Development Bank of China (ADBC).

[3]While there is no uniform definition of policy lending, policy loans tend to meet the following criteria: they are made at the request of the Government to promote its economic, industrial, and sectoral polices and to ensure funding for priority activities; and they may or may not meet banks' commercial criteria for loans.

[4]The divestiture process was largely completed in 1996.

Appendix 2

Financial Reform Measures

Central Bank Independence

Under the old system, the People's Bank of China (PBC, central bank) performed both central and commercial banking functions. Bank loans were allocated on the basis of directives received from the economic bureaucracy in line with planned targets. There was no effective control of money supply as both the State and any sick State-owned enterprises (SOEs) could borrow from the bank almost without limit.

Although the PBC was formally entrusted with central banking functions in 1984, its control over the money supply was weak. In the face of intense demand for financing from provincial governments, which became increasingly powerful, bank credit expanded rapidly at an annual average rate of 23.6 percent during 1987-1992. The PBC put up minimal resistance to the breaching of annual credit targets as governments at all levels and SOEs pursued their aggressive development strategies.

The process of thoroughly overhauling the banking system began in 1993. The program included the transformation of the PBC into a kind of Chinese Federal Reserve. A very bold attempt was made at the National People's Congress in March 1995 to make the PBC independent from the executive arm of the Government and to remove it from the political influence of the Communist Party. However, in the face of strong opposition, a compromise Central Bank Law was passed. The new law renders local branches of the PBC independent of the local government.

The new PBC Law is an important landmark in monetary policy development, giving the PBC the power to perform the central bank functions of monetary policy management and supervision of the financial institutions. While the new law still gives the State Council a leadership role in formulating and implementing monetary policies, it also guarantees the PBC a high degree of independence from other levels of government and individuals. The PBC is endowed with its own capital and must publish its balance sheet and profit and loss statement on an annual basis. Losses sustained by the PBC are to be offset by State allocation, and the PBC is not to finance the budget except under exceptional circumstances.

Interest Rate Control

The State commercial banks can only adjust their lending rates within a specified band around officially determined rates. Thus, the marginal lending rate was not fully market driven and open market operations (the sale and purchase of Government bonds to influence liquidity) operated less efficiently than would otherwise be the case. The regulated interest rates were well below potential market rates and negative in real terms prior to 1995-1996.

However, policy reform has been moving rapidly since 1994. By mid-1996, interest rates in the short term and the interbank markets had been fully liberalized. Bank interest rates have been frequently adjusted to reflect the inflation rate, and are now positive in real terms.

Credit Control

Until 1996, the main monetary policy tool was the credit plan, under which the PBC set credit limits on the State commercial banks, thereby controlling the volume of new credit. Before 1994, the central office of the PBC set credit limits, but the local PBC branches could adjust their credit ceiling by 7 percent on either side of this limit. Since 1994 the local PBC branches have lost their right to adjust their credit ceiling. However, local branches do have the right to determine the distribution of credit quota. Until recently, the credit plan operated in conjunction with more indirect instruments like open market operations and the interbank credit market.

In 1994, credit ceilings on financial institutions other than specialized banks were eliminated and replaced by regulations regarding assets and liability and risk management. The credit plan applied to State-owned commercial banks was abolished in January 1998.

Bank Supervision

The focus of supervision has been shifting toward prudential supervision and strengthening the financial institutions' internal system of risk management control. The national supervision plan is formulated at the PBC head office, and on-site inspections of financial institutions at the national level are carried out. Regular on-site inspections are scheduled once every three years for domestic and foreign banks and nonbank financial institutions (NBFIs).

Measures taken in recent years have sought to place more emphasis on prudential, rather than economic, regulation of the banking system. In addition to the introduction of the asset/liability ratio management system, the PBC has instructed all commercial banks to form an internal audit department to monitor risks and improve internal controls. Since 1996, supervision of the rural credit cooperatives has become the direct responsibility of the PBC, and efforts are being directed toward increasing the quality and frequency of on-site examinations of all financial institutions. To this end, the PBC has established a training institute to upgrade the prudential supervision skills of its 12,000 bank supervisors.

The PBC also conducts off-site monitoring of financial institutions' asset/liability ratios on a regular basis. The focus of off-site supervision is on monitoring bank compliance with 16 prescribed asset/liability ratios, based on monthly and quarterly reporting by the banks of some 850 items, including both prudential indicators as well as other statistical information.

Capital Adequacy Standard

The capital adequacy standard was first adopted in Shenzhen, the testing ground of the PRC's economic reform. This system requires banks to have sufficient capital, and uses capital to restrict liabilities. The purposes are to ensure the quality of assets and to restrict the risks involved.

In the transitional period (over the next few years), the PBC will concentrate mainly on adjustment and control of the credit ceiling and the proportions of deposits and loans of commercial banks. Its guidelines are as follows: for the specialized banks, the growth of credit loans (i.e., loans included within the credit ceiling) should be less than 75 percent of the average growth of deposits during every 10-day period; for other commercial banks, credit loans should not exceed 20 percent of deposits; and for urban credit cooperatives, credit loans must not exceed 75 percent of total loans (70 percent in 1994). For NBFIs, there is also a requirement relating to the percentage of loans vis-à-vis deposits; trust loans (investment) are not to exceed 20 times their total capital, and trust loans from their own resources must not exceed 75 percent of their deposits.

Criteria for Entry

Currently, Chinese bank regulations have some provisions dealing with the capital requirement for banks and NBFIs. The required minimum paid-in capital are as follows: (i) national bank with branches, RMB2 billion; (ii) national bank without branches, RMB1 billion; (iii) regional bank, RMB0.8 billion; (iv) cooperative bank, RMB0.8 billion; (v) autonomous branches established by the above bank categories, 30 percent, or 50 percent of that of the parent banks. If the above categories of banks wish to engage in the foreign-exchange business, 30 percent of the minimum paid-in capital shall be in foreign exchange.

However, unlike regulations in Western countries, Chinese bank regulations have not yet stipulated the qualifications of management, the development of a reasonable business plan and projections, and the financial strength of the proposed owners.

Separation of Commercial Banking from Investment Banking

The 1992-1993 financial chaos due to many banks' involvement in investment in the securities market led to the recent regulation requiring all banks to divest themselves of investment banking affiliates. The Commercial Bank Law stipulates that commercial banks are not allowed to engage in securities trading and underwriting, investment in nonbank financial enterprises and productive enterprises, and trust investment.

Asset Diversification and Loans to Insiders

In the PRC, commercial banks are not allowed to invest directly in productive enterprises and to own equity in nonfinancial firms. Hence, the issue of lending to insiders or related parties does not exist. However, if the PRC adopts the suggestion of debt-equity swap (for the purpose of cleaning up bad debt accounts due to nonperforming loans borrowed by SOEs) made by some economists recently, it would have to decide the extent of lending that would be permitted for insiders. Currently, the PRC's Commercial Bank Law stipulates that a commercial bank cannot lend to a single borrower the amount of more than 10 percent of the bank's capital.

The Chinese regulator should consider reaching a proper balance between prudential control, which requires prohibition of insider lending, and development, which suggests close ties between banks and nonfinancial firms. Currently, the problem of SOEs' nonperforming debt is the biggest headache of the State banking system. Debt-equity swaps, which allow the banks to turn themselves from creditors to shareholders of the SOEs, can substantially increase the banks' power and incentive to closely monitor the firms' management. This is at least an option to be tried. Once a bank becomes a large shareholder of a firm, naturally it tends to give favorable treatment to this related firm. A certain degree of risk associated with lending to insiders is a necessary expense in restructuring SOEs at this difficult moment. In many Western countries, a lending limit of 15 percent of the bank's capital is generally considered reasonable; and in high-income countries, the limit is normally set between 15 and 20 percent. The PRC's 10 percent limit stated in the Commercial Bank Law seems somewhat over-restrictive. In addition, under the current system, each firm is allowed to borrow from only one bank. Without changing this arrangement, the 10 percent limit is unlikely to be met by most bank branches.

Financial Opening

Foreign banks have been allowed to open branches in Shanghai and in 13 other cities, and eight foreign bank branches were permitted in early 1997 to engage in limited local currency business.[1] Currently nine foreign banks are granted permission to engage in local currency business.

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[1] A joint-venture bank was also granted permission to engage in local currency business.