

China's Bank Reform and the Roles of Sovereign Wealth Fund

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Table of Contents

List of Abbreviations	74
1. Introduction of China's bank reform	75
1.1 Stage 1 (1978–1993): Rebuilding the financial system	75
1.2 Stage 2 (1994–1997): Regulating the financial system	76
1.3 Stage 3 (1998–2002): Deepening reform of state-owned commercial banks	76
1.4 Stage 4 (2003–present): Public listing of state-owned banks	77
2. The roles of SWF in China's bank reform	79
3. Future challenges	82
References	84

List of Abbreviations

ABC	the Agriculture Bank of China
ADBC	Agricultural Development Bank of China
BOC	the Bank of China Bank of China Ltd.
CBC	the Construction Bank of China
CBRC	the China Banking Regulatory Commission
CCB	China Construction Bank Corporation
CDB	the China Development Bank
Central Huijin	Central Huijin Investment Ltd.
Chexim	the Export-Import Bank of China
CIC	China Investment Corporation
ICBC	the Industrial and Commercial Bank of China Industrial and Commercial Bank of China Ltd.
PBOC	the People's Bank of China
SOEs	state-owned-enterprises
SWF	Sovereign Wealth Fund

1. Introduction of China's bank reform

In the late 1970s, China was still a centrally planned economy, with the government controlling and planning almost all business activities. The government ruled not only the capital allocation processes, but also production plans, labor markets and product markets. Most economic activity was in the hands of state-owned-enterprises (SOEs), which commonly did not prioritize wealth maximization. Rather, the objectives of SOEs focused on fulfilling the government's economic plans and serving social objectives such as achieving a high employment rate. Chinese banks mainly served SOEs and bank loans were allocated according to political priorities, rather than on the basis of purely economic considerations, which resulted in low levels of efficiency and led to a large proportion of nonperforming loans in the state-owned banking sector.

To solve these problems, China's banking industry was subject to a series of reforms, articulated in four distinct stages.

1.1 Stage 1 (1978–1993): Rebuilding the financial system

Prior to 1978, the Chinese financial system was structured as a mono-bank model, in which the People's Bank of China (PBOC) acted simultaneously as both a central bank and a commercial bank. In 1978, the government began to implement banking reforms focused on adjusting the structure and operations of China's banking system. A two-tiered banking system emerged and various banking functions were separated from the People's Bank of China as the latter began to truly act as central bank. Four specialized state-owned banks--the "Big Four", each focused on a different market segment--emerged: the Bank of China (BOC) focused on foreign exchange business, the Agriculture Bank of China (ABC) with a focus on agriculture finance, the Construction Bank of China (CBC) with emphasis on large infrastructure project finance, and the Industrial and Commercial Bank of China (ICBC) which served city savings and lending businesses.

This strict separation of functions was somewhat relaxed in 1985, when the PBOC announced a new policy of encouraging competition between banks. This, in turn, led to overlap among banks in terms of target business sectors.

In 1986, the first domestic joint-equity bank was established, the Bank of Communications. Thereafter, various commercial banks were set up, such as Shenzhen Development Bank, China Merchant Bank, China Everbright Bank, Shanghai Pudong Development Bank, Fujian Industrial Bank and Hua Xia Bank.

During this stage, there was very limited competition among banks, because they served mainly as policy-lending "conduits" for the government, and proper incentives for management were lacking. Despite the separation of functions, performance of the banking system remained poor, mainly due to government influence in the fund allocation process.

1.2 Stage 2 (1994–1997): Regulating the financial system

During the second stage, the government began transforming state-owned specialized banks into state-owned commercial banks. This involved numerous reforms. First, as it became increasingly clear that policy lending was leading to deterioration in asset quality in all banks, the government decided to establish financing vehicles dedicated to such political, or social, lending, in order to allow other banks to pursue purely commercial goals. Hence, three specialized “policy” banks were established, the China Development Bank (CDB), the Export–Import Bank of China (Chexim), and Agricultural Development Bank of China (ADBC).

Second, two broad new pieces of legislation were promulgated in 1995, the Central Bank Law and the Commercial Bank Law. The former clearly established the structure and role of the Central Bank, while the latter focused on the governance of commercial banks. The Commercial Bank Law prompted autonomous management, but also called for banks themselves to assume responsibility for risk, for profit and loss, and self-discipline. Finally, also in the spirit of increasing the stability of the financial system, credit ceilings were established.

During this stage, the banking sector was still in transition. Despite initial attempts at encouraging banks to follow economic, rather than political, priorities, government intervention and influence were still very strong.

1.3 Stage 3 (1998–2002): Deepening reform of state-owned commercial banks

By the end of the 1990s, it became obvious that political lending was still pervasive, and leading to very high proportions of nonperforming loans (NPLs). In fact, most state-owned banks were technically insolvent. As the Asian Financial Crisis developed, the Chinese government advocated a series of additional reforms of state-owned banks in order to ensure financial safety. In 1998, the Ministry of Finance recapitalized the Big Four by issuing USD 32.6 billion of 30-year special government bonds and using the proceeds to enhance the banks’ capital adequacy ratios. One year later, China’s government established four asset management companies, aiming to take over the bad assets of the Big Four and the China Development Bank. Accordingly, most nonperforming loans were transferred at face value to the asset management companies, further strengthening the banks’ balance sheets.

Other measures were undertaken as well, mostly aimed at improving the governance of banks. These included the strengthening of internal management, the elimination of credit ceilings, and the imposition of managerial performance assessment linked to assets quality and loan portfolio performance. The reorganizations also involved dramatic

staff cuts, leading to a loss of over five hundred thousand jobs at the Big Four between 1998 and 2002.

Despite the many reforms made at this stage, banks still confronted many problems, especially capital constraints. Bridging the funding gap was a constant challenge and the capital supplemented by the Ministry of Finance was only temporarily sufficient. Despite multiple recapitalizations, banks were quickly becoming, once more, undercapitalized. The culprit, as before, was the high proportion of nonperforming loans, which analysts attributed largely to political interference with the lending process. Perversely, every round of government-led recapitalization led to a banking system even more closely tied to the political class. Clearly, governance reforms in the banking sector had not been fully successful; government ownership was still leading to political interference in the capital allocation process, despite the various attempts at reform. It soon became clear that, in order to survive, the Chinese banking sector had to be transformed into a modern banking system. The government had to impose governance reforms, while at the same time protecting the banking sector from the deleterious consequences of political interference and oversight.

1.4 Stage 4 (2003–present): Public listing of state-owned banks

After three stages of reform, banking governance and governmental interference were still major unresolved issues. After the turn of the century, the Big Four banks, whose combined asset accounted for 70% of the Chinese banking system, remained the top concern and priority in the national economy. Problems generated by nonperforming loans and deteriorating asset quality threatened to impede economic development. Hence, the Chinese government decided to further deepen bank reform by focusing on improving the governance of state-owned banks. The process of reform involved four steps: restructuring, recapitalization, introduction of one or more strategic international investors and, finally, public listing.

In the restructuring phase, the major goal was to reduce exposure to nonperforming assets and introduce new shareholders. By May 2004, most of bad assets were, once more, stripped off and transferred to four asset management companies. After that, Bank of China Ltd. (BOC), China Construction Bank Corporation (CCB), and Industrial and Commercial Bank of China Ltd. (ICBC) were established. By the end of 2004, the nonperforming loan ratio of CCB had decreased to 3.92%, the capital adequacy ratio reached 11.29%, and the core capital adequacy ratio hit 8.57%. The nonperforming loan ratio of BOC decreased to 5.12%, while the capital adequacy ratio and the core capital adequacy ratio rose to 10.04% and 8.48%, respectively.

The second step of the process was recapitalization through a newly established vehicle, Central Huijin Investment Ltd. (Central Huijin). Central Huijin was established at the

end of 2003 as a wholly state-owned company, authorized by the State Council to exercise rights and obligations as an investor in major state-owned financial enterprises. Yet, Central Huijin, despite being government-owned, was managed by an independent team. Central Huijin assumed stakes in a number of financial enterprises including large commercial banks, securities companies, financial holding companies and insurance companies and so on.

Between 2003 and 2005, Central Huijin used foreign reserves to infuse USD 22.5 billion into BOC, USD 22.5 billion into CCB, USD 15 billion into ICBC and, later, USD 19 billion into ABC. Central Huijin became a controlling shareholder in each of the Big Four, with the goal of addressing the ever-present governance issues. During the share-holding system reform of state-owned banks, in order to ensure the safety of injected funds, Central Huijin took a significant number of board of director seats, usually exceeding a third of all positions. This system allowed Central Huijin to exercise veto power in significant affairs. These recapitalization and governance reforms were seen as steps towards public listing of the Big Four.

The third step was to attract international strategic investors. In 1996, Asian Development Bank (ADB) became the first international strategic investor to acquire a small portion of equity in China Everbright Bank (a domestic joint-equity bank). This represented a further partial privatization of a Chinese banking firm although the very first privatization can be traced back to 1991, when Shenzhen Development Bank, a domestic joint-equity commercial bank, successfully listed on the Shenzhen Stock Exchange. More international strategic investors were introduced after 2001, when China entered the WTO. From 1996 to 2005, 14 banks were partially sold to foreign investors, including 5 city commercial banks, 6 domestic joint-equity banks, and 3 of the Big Four. Investment by foreign investors boosted market confidence in Chinese banks and it was hoped that the new shareholders would improve governance standards.

The fourth step was to encourage banks to conduct initial public offerings. The first listings were all on the Hong Kong Stock Exchange. In June 2005, the Bank of Communications went public, raising more than USD 2 billion. In October 2005, CCB raised USD 8 billion. In June 2006, BOC raised USD 11.2 billion on the Hong Kong Stock Exchange and USD 2.5 billion on the Shanghai Stock Exchange. In October 2006, ICBC raised about USD 16 billion on the Hong Kong Stock Exchange and USD 5.9 billion on the Shanghai Stock Exchange, making it the world's biggest IPO at the time. In July 2010, ABC was listed on Shanghai Stock Exchange and Hong Kong Stock Exchange simultaneously, IPO scale reached USD 22.1 billion.

IPOs by state-owned banks provided new financing but also increased transparency and led to monitoring by shareholders, which in turn led to improvements in corporate governance and operational efficiency. The nonperforming loan (NPL) ratio of ICBC decreased from 2.74% in 2007 to 0.94% in 2011; BOC's NPL ratio declined from 3.12%

in 2007 to 1.0% in 2011; CCB's NPL ratio declined from 2.60% in 2007 to 1.09% in 2011. Also by 2011, capital adequacy ratios of state owned banks had risen to 13.17% for ICBC, 12.97% for BOC, and 13.68% for CCB.

2. The roles of SWF in China's bank reform

Central Huijin is a wholly state-owned investment company established in 2003 under the Company Law of the People's Republic of China.

The purpose of setting up Central Huijin is to make equity investments in major state-owned financial enterprises in accordance with authorization by the State Council, and shall, to the extent of its capital contribution, exercise the rights and perform the obligations as an investor on behalf of the State in accordance with applicable laws, to achieve the goal of preserving and enhancing the value of state-owned financial assets.¹

The Company shall not conduct any other commercial activities, and shall not interfere with the day-to-day business operations of the state-owned major financial enterprises it controls.

The scope of business of the Company is as follows: to accept the authorization of the State to make equity investments in state-owned major financial enterprises.

In 2007, it became a wholly-owned subsidiary of China Investment Corporation (CIC). Currently, Central Huijin holds stakes in 6 commercial banks, 7 securities companies, 2 financial holding groups, 1 insurance company, 1 reinsurance company and 1 asset management company. The number of company held has increased from 11 on June 30, 2009 to 18 at the end of December 2011 (as shown in Table 1).

¹ See http://www.huijin-inv.cn/hjen/aboutus/aboutus_2008.html?var1=About.

Table 1: Companies held by Central Huijin Investment Ltd. as of December 31, 2011.

name	total share capital	Central Huijin's holdings	
		holding	percentage
China Development Bank	306.711	146.092	47.63 %
Industrial and Commercial Bank of China	349.083	123.694	35.43 %
Agricultural Bank of China	324.794	130.310	40.12 %
Bank of China	279.147	188.701	67.60 %
China Construction Bank	250.011	142.836	57.13 %
China Everbright Bank	40.435	19.558	48.37 %
China Reinsurance (group) Corporation	36.408	30.913	84.91 %
*New China Life Insurance Co., Ltd	3.117	0.974	31.26 %
China Jianyin Investment#	20.692	20.692	100.00 %
China Galaxy Financial Holding Company Ltd.#	7.00	5.50	78.57 %
Shenyin & Wanguo Securities Co. Ltd	6.716	2.50	37.23 %
*China International Capital Co., Ltd.#	0.125	0.054	43.35 %
Guotai Junan Securities Co., Ltd.	4.700	1.00	21.28 %
*China Securities Co., Ltd.	6.100	2.44	40.00 %
*China Investment Securities Co., Ltd.#	5.00	5.00	100.00 %
*USB Securities Co., Ltd.#	1.49	0.209	14.01 %
*China Everbright Industry Group Ltd.#	4.40	4.40	100.00 %
*Jiantou Zhongxin Asset Management Co., Ltd.#	1.90	1.330	70.00 %

Notes:

Total share capital and Central Huijin's Holdings/contributions are in billions shares for joint stock companies and billion Yuan for companies with limited liability (include wholly stated-owned companies) unless indicated otherwise.

"#" represents companies with limited liability and stated-owned companies.

"*" means companies held after June 30, 2009.

Sources: <http://www.huijin-inv.cn/>

Through many years operation, the role it plays is obvious to all.

First, Help state-owned banks build modern banking system.

Take a trial to inject foreign reserves into state-owned banks rather than supplement funds through the Ministry of Finance, solve the problem of funding constraint of the latter, make banks meet the requirement of capital adequacy ratio, ensure the successful listing of state-owned banks on H-share and A-share markets, gain competitive investment return and dividend revenue, help banks complement transition from state-owned commercial banks into modern state-owned share holding banks. As a result, the proportion of nonperforming loans has declined sharply and capital adequacy has greatly improved.

Second, improve financial institution's governance structure.

Central Huijin manages state-owned financial institutions assets through dispatching directors directly to its holdings banks and security companies, those directors' salaries come from Central Huijin. They vote in the board of directors according to their professional ability, instead of administrative orders constraint through 'documents with red title' (Hong tou wen jian) issued by high level management, which often happens in State organs, this shows a great progress in corporation governance.

But Capital constraints have been the major problem for the Big Four all along. Despite funding injections by the Ministry of Finance and Central Huijin, and financings from public listings, the problem remains unresolved. In year 2010 recapitalization wave of state owned banks has also been politically controversial.

One of the problems highlighted by analysts is the circular nature of some of the refinancing in 2010. Huijin raised capital in the domestic interbank bond market through multiple rounds bond issues. The purpose was to recapitalize three largest state-owned banks, one policy bank and one insurance company. But more than 80 % of Central Huijin's first bond issue was bought by state-owned banks, thus raising questions about whether any new funds have really been injected. Overall, rather than building new reserves, recent bond sales may have increased risk in the banking system. In a sense, banks were providing funding to themselves but no fresh cash flowed in. The rating agency Moody's criticized the whole process, noting that recapitalizing banks with bond proceeds purchased by the same banks effectively increases the leverage of the entire banking system. Moody's expressed doubts about the sustainability of this practice, noting that problems are likely to arise if leverage continues to increase while economic growth slows.

Central Huijin took exceeding a third of all positions in board of director seats, usually this system allowed Central Huijin to exercise veto power in significant affairs, therefore through directors designated by Huijin, Huijin may influence decision making in board of directors in its share holding financial institutions.

Besides, Central Huijin imitates Singapore Temasek model to support state owned financial institutions reform through equity investment, and gradually develop into a huge financial holding company. At the end of December 31, 2011, Central Huijin ex-

tended its holding companies to 18 from 11 in June 30, 2009. This trend will continue in the following years. But Central Huijin is not Temasek after all, there are many differences existing. Huijin-related companies may compete with private companies under unfair operation environment.

3. Future challenges

Through decades of reform, the Chinese banking system has undergone dramatic transformations. A modern banking system has been established, property rights have been strengthened, and corporate governance is improved. Bank's performance is showing excellent with various good indicators according to annual report. But there are many uncertainties for banks to face in future:

The Chinese bank's profit comes from the stable interest spread for many years. The net interest income account for 66.2% among banking institutions income in 2011, net fee-based income was only 14%. With the further marketization reform of Interest rate, interest spread will be narrowed. Banking will face much more pressure than before. In order to remain profit, the only way is to actively change its operating model, add intermediary business income.

In order to tackle the financial crisis, the government pushed out a stimulus package of USD 600 billion in 2008, which helped Chinese banks extend new loan in excess of one trillion USD. Most new loans were provided to large state-owned enterprises, which then invested money in the real estate market, triggering fears of a new real-estate bubble. Part of new loan will produce NPL in the next few years.

Another emerging issue is the potential bad loans produced by municipal government financing vehicles. Municipal governments are not allowed to issue bonds or borrow loans from banks, so many of them set up their own financing vehicles to borrow from state-owned banks. Based on audit results of the National Audit Office, until the end of June 2010, there were about RMB 10.7 trillion outstanding loans issued through the municipal government financing vehicles, nearly 20% or 78 municipal governments in the whole nation had the debt ratio higher than 100%, and some areas appeared overdue debts. Besides, investigation showed that Among RMB loans, loans through financing platform accounted for not more than 30%, and state-owned commercial Banks and policy Banks become the main supply. The potential bad loans risk produced by municipal government financing vehicles is not allowed to ignore because of its long maturity, large amount and supervision difficulty.

With the improvement of capital regulation, the pressure of capital supplement will increase, return on capital will be compressed. Especially after the financial crisis, the global financial regulators have further strengthened the capital requirements. According to the China Banking Regulatory Commission (CBRC) about "the Guiding Opinions

on the Implementation of New Regulatory Standards in China's Banking Industry", three minimum capital adequacy ratio requirements on commercial bank were demonstrated, namely the core tier one capital adequacy ratio, the tier one capital adequacy ratio and capital adequacy ratio were not less than 5%, 6% and 8%. Besides, counter-cyclical capital regulatory framework was introduced, including 2.5% retained excess capital and 0-2.5% of the reverse cycle excess capital. At the same time, the systematic importance banks were required to meet 1% additional capital requirements. Capital constraints will still accompany with bank development, how to solve this tough problem? Central Huijin will confront test again.

References

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