Economic Analysis

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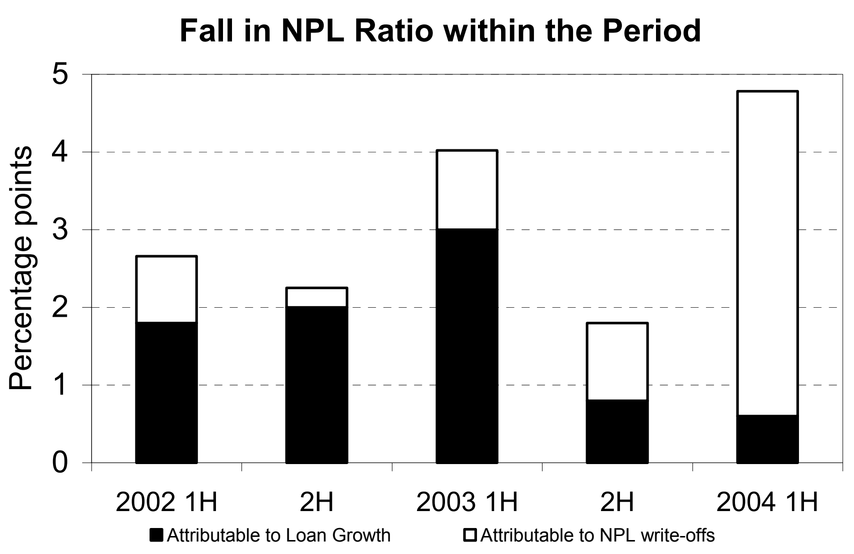
# Banking Reform in the Mainland

The Mainland's banking sector has made great progress since reform was initiated with a major capital injection into the banking sector in 1998. However, a great deal of work remains to be done before the authorities can declare victory. We believe that the Mainland government will continue to retain control of the banking industry. However, the government is also likely to allow more foreign banks to become strategic partners in state-owned banks, to impart know-how and to generate profits that can be plowed back to relieve the burden of Non-Performing Loans (NPLs). Success in banking reform will be the prerequisite for other major reforms in the financial sector.

## Interim report card

There has been significant improvement in asset quality at the four state-owned banks over the past few years. The NPL ratio at state banks has halved from an estimated 31.1% at the end of 2001, to 15.6% in June 2004. Moreover, the authorities are getting increasingly serious about tackling the NPLs. Rather than using loan growth to dilute the NPL ratio, they have sped up write-offs over the past year. In the first half of 2004, 4.2 percentage points of the decline in the NPL ratio was attributable to write-offs. This is a marked deviation in style from 2002 and the first half of 2003, when write-offs accounted for only 2.1 percentage points of the decline in the NPL ratio, while the diluting effect from explosive growth in loans outstanding played a far greater role.



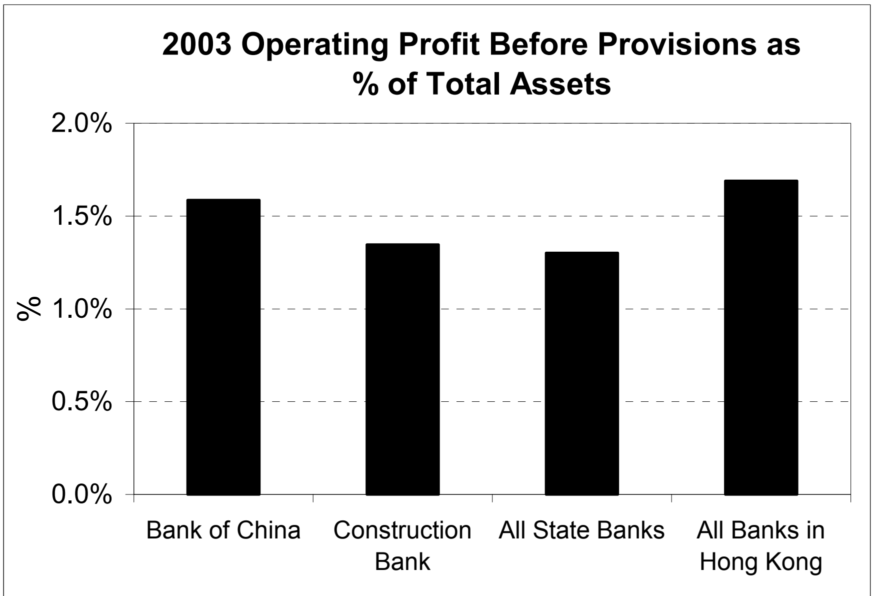

*Sources: People's Bank of China; Bank of East Asia*

Yet, the bill for solving the NPL problem is still a sizable one. Official figures for NPLs outstanding at state banks stood at RMB 1,523 billion at the end of the second quarter, and more than RMB 800 billion of non-performing assets remain to be processed at the four Asset Management Companies (AMCs). To put this in perspective, the sum of the two equals 20% of last year's Gross Domestic Product (GDP) in the Mainland. More pessimistic estimates, including those from Standard and Poor's, would put the bill at around 40% of GDP. Given the current low ratio of public debt to GDP, at approximately 20% compared to 40-60% for the US and some leading European countries, the burden of the non-performing loans to China is still within the capacity of the economy.

Of more concern is the ability of the banking system to prevent the creation of future bad loans. This is particularly so as the country's loan portfolio has expanded by six trillion yuan since 2001. It will be of considerable importance to note the level of non-performing loans that are generated from this growth in new loans.

### State banks to pay their own bills

Meanwhile, although headline net income figures from the state banks were less than satisfactory, the banks have actually been quite profitable in the past few years, if the cost of processing the historical burden of NPLs is excluded. Operating profit before provisions for the four state banks totaled RMB 190 billion in 2003, and the figure for the first half of this year was already at RMB 120 billion. Moreover, the ratio of operating profit before provisions to total assets for Bank of China and China Construction Bank in 2003 were 1.59% and 1.35% respectively, fairly respectable considering that the figure for banks in Hong Kong was 1.69%. In fact, the state banks have been using the majority of their operating profits to write off RMB 100-150 billion of the historical NPL burden annually.



*Sources: Annual Reports from Banks; People's Daily; People's Bank of China; Hong Kong Monetary Authorities; Bank of East Asia*

Therefore, the state banks themselves will be able to contribute significantly to repaying the NPL bill if they can maintain this high level of profitability; this consideration may dictate the direction of future banking reform. In particular, two reasons have been behind the high profitability for state banks. Firstly, banks in the Mainland enjoy a comfortable margin on interest income. Deposit rates are kept low, and the public has few alternative choices for investing and saving. At the same time, the massive market share of state banks, at 60% of all assets in the Mainland banking system, will ensure that most of the profit from this lucrative market will go into their coffers. Consequently, the Mainland authorities are not likely to loosen their grip on interest rates, nor would they be inclined to allow foreign competitors to shake up the state banks' dominant market share.

### Role of foreign strategic partners

However, it is not wise to suggest that the Mainland authorities will stifle banking reform for the sake of milking profits from the sector. Slow reform in the banking sector would come at the cost of a less efficient financial system. This, in turn, would be a drag on economic growth. In the past, many of the loans in the Mainland were made to less efficient state-owned enterprises, while private enterprises faced difficulty in getting funds for expansion even though many of them were actually very profitable. This has changed in recent years, as Chinese banks are restructured to become more responsive to market demand. However, this is a challenging task, considering that Chinese state banks have 1.36 million employees. The creation and mastering of proper risk management, credit assessment and other modern banking systems will take a long time, and the cost of learning could be very high if the process is rushed. But, while the one-step-at-a-time approach may prevent costly mistakes, the pace of reform could be too slow to meet the urgent needs of private companies that must face fierce foreign and domestic competition.

As a result, the Mainland must strike a fine balance between extracting profits from the banking sector and the welfare of the overall economy. In this regard, we believe that introducing strategic partners to state banks would be a good option and create a win-win situation. Major international banks have been eyeing a piece of the Mainland banking pie, and significant stakes at the state banks can give them quick access to a burgeoning market. On the other hand, the Mainland government can retain much of the return from this profitable sector while gaining a hand on reform at the same time. In particular, experience from the foreign partners can help the state banks bolster their under-developed non-interest income businesses and would actually further strengthen their profitability. Moreover, unlike a Latin American styled full-fledged opening of the banking sector, it would prevent big foreign players from competing fiercely for market share and causing instability in the banking system.

**Conclusion**

The success of banking reform will be a necessary pre-condition for further financial reforms. Moves such as stock market reform, relaxation of capital controls, and convertibility of the Renminbi would open up alternative investment channels, eating into the deposit base at state banks and affecting their profitability. Still, the Mainland authorities cannot delay much-needed reforms solely for the sake of protecting the banking sector.

We believe that introducing foreign strategic partners to Mainland banks offers the best balance between paying the NPL bill and speeding up reform in the banking sector. Furthermore, there is room for a more aggressive approach at smaller Mainland banks, as the whole banking system can benefit from the import of modern management skills through foreign investment. The effect on profitability of the state banks would be marginal, as the smaller banks have only a minor market share. Incorporation of Bank of China and China Construction Bank, as well as HSBC's stake in Bank of Communications, have been key milestones in this direction.

The Mainland has committed to fully opening its banking sector by the end of 2006, under the World Trade Organization (WTO) accession agreement. The looming deadline means that the banking sector cannot afford to continue to delay reforms.