CHINA'S BANKING TRANSFORMATION

THE UNTOLD STORY

JAMES STENT

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Preface

IN THE COURSE of my three years of service as an independent director on the board of China Minsheng Bank, and ten years at China Everbright Bank—in total thirteen years spanning 2003 through 2016—I watched China's banks transform from damaged relics of the planned economy into modern commercial banks. Although much further development is needed in the Chinese broader financial system, the change in the quality of Chinese banks that I watched over those thirteen years can only be described as a "night and day" transformation.

Yet most accounts in the media, in financial analysis, and even in much academic work give little recognition to what has been achieved in the Chinese banking sector over recent years. Indeed, much of the literature, popular and specialized, is highly skeptical of the Chinese banking sector. The widespread acceptance of this negative view has led to writing this book in order to provide a different, and more balanced, perspective than is found in the consensus negative view.

My involvement with Chinese banking began on a summer morning in 2003, when I walked into a reception room of the head office of the China Minsheng Bank for a meeting with the bank's founder and chairman, Jing Shuping. Since its founding in 1996, Minsheng had maintained its head office in a venerable building on Zhengyi Road, just east of Tiananmen Square in the former Legation Quarter. Unlike much of Beijing, which has been extensively rebuilt, the former Legation Quarter around Zhengyi Road, including the Minsheng Bank head office, had remained architecturally intact. The well-preserved building was constructed in 1910 as the Beijing branch of the Yokohama Specie Bank. Architecturally it is an Asian transplant of late nineteenth-century brick and stone Dutch architecture in vogue among Japanese at that time.[1]

China's ongoing reforms had recently mandated modern corporate governance practice in listed companies such as Minsheng Bank. Under the new requirements, Minsheng's board should include four independent directors. Jing Shuping had selected three Chinese professionals to be independent directors, but he also wanted to identify a foreigner with both banking experience and Chinese language ability to serve as the fourth independent director. Consultation with, the International Finance Corporation, a World Bank affiliate, which was advising Minsheng at that time, led to the suggestion that I might be a candidate.

An inner door of the ornate century-old reception room opened, through which walked Chairman Jing, dapper in well-tailored suit and tie, but walking slowly at the age of 83. Slight of frame and frail in appearance, he nonetheless exuded warmth, energy, charm, and a piercing intelligence. Born into a Shanghai capitalist family, he had assisted his father prior to 1949 in running the family's manufacturing business, and was one of the capitalists who had chosen to stay in China after the civil war ended. The Cultural Revolution years were not kind to him, but he had endured and gone on to become one of the most respected and senior non-communist party figures in China during the '80s and '90s, serving as vice chairman of the People's Consultative Congress and as chairman of the All-China Federation of Industry and Commerce. Through these positions, he developed a broad network of contacts in the emerging Chinese entrepreneurial world. Jing and several other leading entrepreneurs in the All-China Federation proposed to the then-Deputy Prime Minister Zhu Rongji that a new commercial bank be established, to be owned entirely by private businessmen. Zhu backed the idea, and the Minsheng Bank was established in 1996, with Jing as chairman of the board, and shareholders who ranked among the wealthiest of China's new capitalists.

Our conversation ranged for half an hour across a variety of subjects, touching on culture, travel, and of course banking. Chairman Jing indicated that I would be nominated as an independent director at the forthcoming annual general meeting of the bank's shareholders, and thus began the Chinese portion of my banking career.

The circuitous path that had led me to that interview with Chairman Jing had begun in 1973, when I joined Citibank of New York as a junior officer in its Asian Division. After brief training in head office, I spent four years in Citibank's Philippine and Hong Kong branches. In Hong Kong I transferred to Crocker National Bank of San Francisco, which assigned me first to Hong Kong, and then to Thailand, where I lived and worked from 1979 through 2002, and again from 2007 to the present time.

Those eight years during the 1970s working in American banks comprised the first stage of my banking career. It was in those two banks that I absorbed the conservative

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[1] Li Luke and Hu Jiezhong, eds., *Beijing Gujianzhu Ditu* (Beijing: Tsinghua University Press, 2009), 204–205.

tenets of an earlier era of banking practice. Those were the last years of the highly regulated era of banking that had been the norm in America since the New Deal reforms of the 1930s. Banking was a stodgy career choice. Yet the American banking system was then relatively stable and the postwar economy was going through a golden era of prosperity.

In those days at Citibank new recruits underwent intensive training in the basics of the profession. We rotated through every department in our training. From the tellers we learned out how to pay out and receive cash and how to balance ledgers at the end of the day, from the foreign department clerks we learned the intricacies of negotiating letters of credit, and so forth. The emphasis was on controlling risk, and on doing things properly. The bank's thick accounting and procedure manual was our bible. I was imbued with the craft of banking, with the precepts of risk control, and with a strong sense of protecting the interests of the depositors and of the bank. Most of what I know and believe to be important about banking, I learned in those early years of my career.

That was the style of banking that had stood America in good stead during the first three prosperous postwar decades. But change was afoot, the Reagan revolution started in 1981, and the rational markets theories of economics gained broad support, providing the intellectual rationale for sweeping deregulation over the next twenty years. The culture and style of Citibank of today is far different from the Citibank for which I had worked.

At just that time, when the banking world was changing, I left Crocker and American banking to join a small, privately owned Thai bank, the Bank of Asia. I was to spend eighteen years with Bank of Asia, during most of which time I was its only foreign employee. The youthful CEO, Yos Euarchukiati, scion of the Sino-Thai family that was the dominant shareholder of the bank, realized that the days of old-fashioned overseas Chinese style banking would soon be over in Thailand. The bank would need to professionalize to meet the challenges of the rapidly developing economy of Thailand. First under Yos, and then under his successor Chulakorn Singhakowin, I worked as part of a team of Thai professionals to change Bank of Asia from a traditional into a modern bank.

My stints with the two American banks had provided me with the fundamentals of the craft of banking as it had been practiced in America prior to the deregulation era. The succeeding years with the Thai bank gave me an opportunity to work inside an Asian financial institution in a developing country, tasked to introduce international best practice and bring about organizational change in a local bank. One of the lessons I learned at Bank of Asia was that change must be sequenced, that "big bangs" within an Asian organization were a likely road to failure. Another lesson was the importance of change management—ensuring that all stakeholders in the organization are fully supportive of the change agenda, and that their interests have been given due respect. If all stakeholders were not "with the program," those left out could all too easily subvert the change agenda. I learned to be patient with a pace of change that might seem unnecessarily slow, but which in the end would prove a reliable path to reaching our objectives. Those lessons in organizational change at the micro level would provide me with insights into understanding how the reform program worked in China at a national level.

The years of modernizing and professionalizing the bank paid off. The Bank of Asia survived the systemic meltdown of the Thai economy during the Asian financial crisis of 1997—the bank's sound management attracting a large capital infusion from ABN AMRO Bank of the Netherlands. From the crisis itself, and from the painful but quick recovery over the next five years, I learned not only about sustainable banking, but also about macroeconomic policy pitfalls in developing countries—real estate and stock exchange bubbles, ill-advised monetary and foreign exchange policies, and the hubris that accompanies rapid economic growth, leaving a country vulnerable to unanticipated shocks.

In 2002 I retired from Bank of Asia, moved to Beijing, and worked on several projects there, including service on the board of Minsheng Bank. I developed the highest respect for Chairman Jing Shuping. Despite his advanced years, and despite having been cut off from the West for thirty years, Jing was keenly aware of international economic and financial currents, was extraordinarily progressive, and immediately grasped new concepts presented to him. The strong growth of the bank in those early years owed much to his leadership and vision.

Shortly after completion of my three-year term as an independent director of Minsheng Bank, I accepted an offer to be an independent director of China Everbright Bank. Both Minsheng and Everbright are listed on the Shanghai Securities Exchange, but Minsheng shares are almost entirely in the hands of private shareholders, whereas, following a recapitalization mandated by the State Council in 2007, the state, through several vehicles, is the majority shareholder of Everbright Bank.

I served two terms (the maximum allowed by governance regulations) of three years each as an independent director of Everbright Bank, starting in 2006 and finishing in 2012. During most of that period, I chaired the Board's Audit Committee, and was also a member of the Risk, Strategy, Nominations, and Compensation Committees. The full board met at least five or six times each year. Committee meetings were held immediately prior to the full board meetings, altogether lasting two or three days. After the completion of my two terms as an independent director, I was elected one of two outside members of the bank's board of supervisors, where I served until the completion of my term in 2016.

Widespread skepticism about Chinese bank quality prevails among both analysts and the general public. I acknowledge that my view that there has been a "night-and-day" transformation of Chinese banks since the 1990s is contrary to the impression conveyed by most foreign media accounts—which generally describe Chinese banks as fragile and inefficient, perhaps headed for crisis. This view has now become widely accepted outside of China. I find these views ill-informed, misleading, and perhaps imbued with a bias, sometimes conscious but generally unconscious, against a system that is avowedly "socialist" at a time when adherents of neoliberalism and market capitalism are intolerant of alternative models.

I felt the need for a corrective to the prevailing gloomy and censorious view, so in 2012 I began the research and writing of this book on the banking transformation to which I had been privileged to be a front-line witness. In the wake of the financial collapse of 2008, the published academic analyses and popular accounts of the failures of banks in America and the United Kingdom have been of high quality and insightful. Collected together, they would fill several bookshelves. Curiously, although journalists and investment analysts have written frequently on day-to-day developments and problems in Chinese banking, only a handful of books, think tank specialist surveys, consultant and rating agency publications, chapters in larger overall studies on China's economy, and academic articles have dealt with the development and prospects of Chinese banks, and most of these are not easily accessible to the non-specialist. I hope this book fills that gap.

Unlike more academic treatments, or journalistic accounts, I have not written from the vantage point of an outside observer or researcher. This book is an account of banking told by a professional banker, with the benefit of access within banks and of input from many Chinese and foreign banking practitioners. This book is not, however, intended to be an authoritative or scholarly history of the development of Chinese banking over recent decades. Such a book is much needed, and hopefully will be written.

China is the second largest economy in the world. A banking crisis in China would have enormous impact on China's economy, and that would rapidly turn into a global economic and financial crisis. Moreover, as China moves beyond Deng Xiaoping's foreign policy of "hiding its light" and asserts itself internationally, how China manages the stability of its banking system, how its banks expand overseas, how its financial system becomes more open and integrated with global systems, and what China thinks about global financial architecture take on global importance. It is therefore imperative that anyone concerned with China's political economy should have a deeper understanding of China's banking system than perusal of the media provides.

Development of the Chinese banking sector, lying at the heart of the nation's economy, can serve as a case study for understanding what happens in other sectors of China's economy, even in non-economic areas. It is my hope not only that readers will take away from this book a clearer picture of Chinese banks, but also that an understanding of the banking sector will provide a prism through which to understand how China as a whole works.

The introductory chapter, "China's Hybrid Banks" sets forth the overall argument of the book that China's banks are hybrid creatures, operating in most ways like modern Western banks, but designed to serve the real economy under the guidance of the Communist Party in a market socialist political economy. The hybrid character of Chinese banks combines extensive borrowing of Western banking practice and concepts of corporate governance with traditional Chinese beliefs in how society and the political economy should be ordered. The result is a banking system that has effectively contributed to national economic growth, but which has attracted a plethora of foreign criticism because it does not adhere to conventional Anglo-American concepts of how modern banking systems should run.

China's banking transformation story would not be comprehensible to non-Chinese readers without explanation of how China's culture and historical development have influenced contemporary Chinese banking, and how Chinese banks fit into the broader political economy. Too often misunderstanding of Chinese banking practice and policies stems from viewing the Chinese system through the lens of a non-Chinese, and particularly Anglo-American, ideological framework that does not take sufficient account of the very different culture and political economy in which Chinese banking is embedded. Chapters 2, "Culture Matters," and 3, "Leninism and Pragmatism: China's Communist Party," provide essential background on Chinese culture and political economy to make the main narrative of the banking transformation comprehensible in the broader context of how China works today. They explain how the persistence in contemporary China of Confucian views of how society should be ordered provide the rationale for strong party-state control of the banks. They also explain the "why" and "how" of the Party's role in Chinese banks, particularly through its powerful Organization Department, which controls senior appointments in the banks.

Chapter 4, "Transformation: From Bursars to Bankers," provides a chronological narrative of the development of Chinese banking over the years since Opening and Reform commenced in 1976. It relates the principal phases of development, the search for a model of banking that would suit China's needs, and the financial turmoil of the 1990s, which led to recognition of the priority that should be given to development of a healthy banking system and thus to Zhu Rongji's dramatic reform program to transform banking into a modern system.

Having related how the transformation took place, Chapters 5 and 6 describe Chinese banking as it is today. Chapter 5, "Bankers," discusses how Chinese banks are managed and governed, the quality of human resources, and the role of the Communist Party in banks. Chapter 6, "Systems," is a more technical chapter discussing the credit quality and risk management, internal controls and auditing, IT capabilities, strategies and nature of competition of Chinese banks. These two chapters are heavily based on my own understanding of how Chinese banks work arising out of my service on the boards of two banks, corroborated by a large number of Chinese and foreigners with sound knowledge of Chinese banking from various different perspectives. What I have written in these chapters has been confirmed by other foreigners and Chinese with firsthand knowledge of Chinese banks.

Chapter 7, "Power of the State," describes how the state exercises control over the banking system indirectly through its coordination of the resources of the "national balance sheet" and directly through ownership of banks and through the financial regulatory authorities.

The achievements of the government in expanding financial access broadly through society and the economy are contrasted with the underdevelopment of "direct finance"—the bond and equity markets—in Chapter 8, "Financial Structure, Deep but Narrow." Chapter 9, "Coming In and Going Out," describes the restricted but nonetheless important role that foreign banks play in the Chinese system, and the challenges that Chinese banks are facing as they expand overseas.

Is China's present banking system, as described in this book, entirely a creature of the present communist regime, or has it arisen out of Chinese ways of organizing the political economy that predate communist control of the country? Is the way in which banks operate within the broader political economy unique to China, or does the Chinese experience bear similarities with the experience of other countries? These questions are explored in Chapter 10, "China's Banks, *Sui Generis*?," through a retrospective of Chinese banking from late imperial times up to the end of the Republican era in 1949, and through looking at two of the other Asian developmental states, Japan and South Korea.

The arguments of those who believe China's banking system remains fragile and heading for crisis are examined in Chapter 11, "Collapsing or Adapting?," followed by a sketch of the principal challenges facing Chinese banks—particularly asset quality issues and the threat from nonbank digitally based competition. The likely course of future banking reform is the subject of Chapter 12, "Reform Directions."

The concluding chapter discusses the challenges China's banks face as the economy transitions into a lower-growth, less investment- and export-dependent economy—the New Normal. The success of the banking transformation in terms of providing the country with a banking system that provides broad financial access, allocates capital efficiently, and is a sustainable and stable system is evaluated.

China's Banking Transformation takes a generally positive view of what has happened in Chinese banking. Some have protested to me that I am ignoring the costs that China has paid in terms of environmental degradation, cultural heritage loss, increased inequality, etc. There is broad agreement among Chinese and foreigners that these are immense problems, but this book is not about those issues. If I were to write a book on those subjects, it would not be a positive story. This book, however, is about banking, which is a positive story.

Others have warned me that the speed of change occurring in China will make anything I write about banking out of date soon after the book is published. There is some truth in that, and no doubt some things in this book will soon be dated. This book, however, is not primarily concerned with the issues faced by banks in 2016 as the book goes to press, but rather seeks to explain the longer-term role that Chinese banks play in the political economy, to explain how Chinese banks work in ways both similar to and different from Western counterparts, and to demonstrate how the nature of Chinese banking arises out of China's culture and is conditioned by its history. I do not expect that any of these will soon change in China.

This book is based on my accumulated experience and observations over the thirteen years that I have served on the boards of two Chinese banks. To my colleagues on the boards and in the management of the two banks, I owe an immeasurable debt. Through the years they have shared with me their hopes and ideas, frustrations and worries, successes and failures, permitting me to become a "member of the team." As the only foreigner in both banks, I have felt honored and privileged. My position on the boards of these banks has provided me with access that has been available to only a handful of other foreigners. I hope that the years of experience I have accumulated over a lifetime of banking and which I have shared with my Chinese colleagues has contributed in some way to the development of these banks.

Despite my privileged access, my personal experience of Chinese banking was limited to what I learned from my work on the boards of two banks and, despite my best efforts, was invariably colored by my American cognitive framework. I expanded my understanding and checked the validity of my book's themes through conducting interviews with approximately 150 people, mostly Chinese, but also foreigners, and in a few cases interviewed the same person more than once. People interviewed included banking practitioners, government officials, journalists, academics, economists in multilateral organizations, and businessmen. Interviews were conducted in Chinese and English languages, depending on the preference of my interlocutor. The people interviewed were all knowledgeable and extremely generous in sharing their views and experience with me. They asked only that I be objective in what I write in this book, pointing out both the strengths and weaknesses of the Chinese system. Those who spent time with me in interviews were too numerous to acknowledge individually here, but I want to express my deep appreciation to all of them for the time they took out of busy schedules to share their knowledge and insights with me. Without their assistance this book could not have been written.

I would like to acknowledge my debt to two people in particular. First is Hugh Peyman, who accompanied me on most of my interviews. Hugh has shared with me his great understanding of China's contemporary economy. His critical challenges to my assumptions and beliefs sharpened my own thinking. Michael Yang provided invaluable research support, and Michael went beyond research to also caution me when I was misunderstanding some aspect of Chinese culture or society.

I have also benefited greatly from first learning about Chinese history, language, and culture in America and Hong Kong fifty years ago, studying under great teachers who conveyed not only their knowledge of China but also their passion for the country, its people, its language and its culture—Frederick Mote, Ch'en Ta-Tuan, Joseph Levenson, Frederick Wakeman, James Cahill, Edward Shafer, Liu Ming, and Liu Yamei, among others.

In writing in this book of my experience working within Chinese banks, I have been mindful not to disclose confidential bank and government material to which I had access.

I would like to thank Michael Aldrich, Robert Binyon, Darrell Duffie, Michael Ipson, Frank Rokers, Andy Rothman, Danny Unger, and Wei Anning for taking the time to read a draft of my manuscript in its entirety and provide me with most helpful suggestions, criticisms, and corrections. Several others also read and commented on sections of the text in which they had expertise: Joern Helms, Dennis McNamara, Keith Pogson, Ed Wu, Xiao Bing, Xu Jun, and Arthur Zou. Their feedback has greatly improved the final product. I am also grateful to David Shambaugh for the encouragement and guidance he gave me. Ultimately, though, I am solely responsible for everything in this book.

Abbreviations

ABC	Agricultural Bank of China
AMC	Asset management company
BIS	Bank for International Settlements
BOC	Bank of China
CAS	Chinese Accounting Standards
CBRC	China Bank Regulatory Commission
CCB	China Construction Bank
CIC	China Investment Corporation
CSRC	China Securities Regulatory Commission
DRC	Development Research Council
GAAP	Generally Accepted Accounting Principles
ICBC	Industrial and Commercial Bank
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
IT	Information Technology
MIS	Management information system
MOF	Ministry of Finance
NDRC	National Development and Reform Commission
NPL	Non-performing loan
OECD	Organization for Economic Co-operation and Development

P2P	People to people
PBOC	People's Bank of China
PSB	Postal Savings Bank
SME	Small and Medium Enterprises
TARP	Troubled Asset Recover Program
WMP	Wealth Management Products
WTO	World Trade Organization

CHINA'S BANKING TRANSFORMATION

Some people think of the financial markets as a kind of glorified casino, with no relevance to the real economy—where the jobs, factories and shops are. But that's wrong. Finance is more like the circulatory system of the economic body. And if the blood stops flowing . . . well, you don't want to think about it.
ALAN BLINDER, 2013[1]

If we combine a planned economy with a market economy, we shall be in a better position to liberate the productive forces and speed up economic growth.
DENG XIAOPING, 2014[2]

We should make good use of the roles of both the market, the "invisible" hand, and the government, the "visible" hand.
XI JINPING, 2014[3]

1 China's Hybrid Banks

THE ECONOMIC DEVASTATION unleashed by failures of Western banks in the financial crisis of 2008 highlighted the central role played by banks in economies and the importance of establishing a proper financial regulatory system. So also did the meltdown of Chinese banking in the 1990s. When they work efficiently, banking systems facilitate economic growth and stability, a happy state of affairs that prevailed in the United States in the two decades after World War II. American banks in that period did perform their role efficiently as a circulatory system keeping the blood flowing in the economy, as described by Princeton economist Alan Blinder in the quote heading this chapter. Moreover, financial system development preceded and enabled general economic takeoff in what are now the advanced nations—including the Netherlands, Britain, United States, Germany, and Japan.[4] The flip side, though, is that irresponsible banking sets off financial crises that bring in their wakes prolonged economic distress.

[1] Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* (New York: The Penguin Press, 2013), 5–6.
[2] Xie Pingru, ed. *Xiaoping Said: Build Socialism with Chinese Characteristics* (Guangzhou: Guangzhou Higher Education Press, 2014), 62.
[3] Xi Jinping, *The Governance of China* (Beijing: Foreign Languages Press, 2014), 128.
[4] Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, NJ: Princeton University Press, 2014), 9, 23–24.

Everyone knows that the economic rise of China over the past four decades is unprecedented in world history. Yet in the 1990s, just as this economic rise was accelerating and China was poised to become an economic player on the world stage, China's banks were mired in bad debt, technically bankrupt, and backward in management and operations. They were not actually commercial banks in the real sense of the word, since they operated as vestiges of the old planned economy model that China was rapidly leaving behind. As China dismantled its centrally planned economy and replaced it with a hybrid capitalist economy increasingly driven by market forces, it studied the workings of Western capitalist economies. It recognized that a system to effectively provide financial intermediation to channel the flow of funds from savings into investment was essential to the workings of a modern market economy. China could not achieve its economic growth objectives if its banking system remained dysfunctional.

Replacing banks of the old planned economy with banks that function well in a more market-based economy—in other words, creation of a modern banking system—became a priority national strategic objective. Achievement of that objective in little more than a decade is one of China's major achievements. Today, the largest Chinese banks are real commercial banks, playing an important role in the nation's economic development.

Market Socialism or Market Capitalism?

China's modernized commercial banks are hybrid creatures—in part resembling Western counterparts, in part shaped by China's political economy framework and by its own cultural heritage. They conform to global best practice in structure, management, and operations. As in Western banking systems, Chinese banks measure efficiency primarily by their creation of shareholder value, as reflected in return on equity (ROE). The published average ROE of the listed Chinese banks over the past few years has been consistently above 15%. In this focus on bottom line profitability, and in the payment of a share of profits to shareholders in the form of dividends, Chinese banks are no different from banks in the market capitalist U.S. and U.K. economies.

This market capitalist banking model is, however, only half the story of Chinese banks. The market capitalist model has been modified to accord with Chinese cultural norms, and it has been adapted to fit China's political economy, which is directed by the Communist Party. The rationale for banking in China and the role that banks play in China's political economy differs from what animates banking in the Anglo-American economy and to a lesser degree from most European banking systems. The rationale for Chinese banks is utilitarian—to be effective instruments for the state in fostering economic development, to serve the real economy. Chinese banks have a dual role to play, giving rise to what I term the hybrid nature of Chinese banks.

This hybrid nature follows the thinking of Deng Xiaoping and Xi Jinping in the quotes at the head of this chapter, in which they spoke of combining the market and the government in the economy, resulting in market socialism (as opposed to market capitalism). Political scientist Sujian Guo explains that if pure laissez faire market capitalist economies lie at one end of the spectrum and pure planned economies at the other end, then in between lie "mixed economies," of which "market socialism" is an apt description of the Chinese mixed economy toward which Deng Xiaoping pointed the way when he launched Reform and Opening in 1978. Guo defines "market socialism as a type of economic system that combines the socialist principle of public ownership with the principle of the market economy, with predominant public ownership in those areas deemed critical to the implementation of socialist principles and social policy."[5] Commercial banking, of course, is one of those "critical" areas.

This hybrid role both arises out of the historical legacy of the communist planned economy and is embedded in traditional Chinese thinking about the proper role of the state in the economy. Chinese banks have enthusiastically adopted and incorporated into their operations international standards of shareholder ownership and governance; systems of risk management, accounting, and internal control; listing on securities exchanges; and focus on value added to shareholders—all designed to promote the efficient management of the banks and to protect the banks from a repeat of the failures of the 1990s. Chinese bank regulatory authorities have put in place a strict supervision system modeled on global best practice. This capitalist packaging should not, however, obscure the reality that Chinese banks are managed not only to create shareholder value but also to play a vital role in promoting Chinese economic development. They must make money for shareholders *and* contribute to national economic development goals, as defined by the Communist Party. This is the essence of banking in China's market socialism and is the fundamental difference between banks of market socialism and Anglo-American market capitalism.

In Chapter 10 I compare the Chinese banking system and the banking systems of nations that practice a form of capitalism, such as Germany, Sweden, Japan, and the Netherlands, whose capitalism is termed "cooperative capitalism" in the social science literature. In those nations, single-minded focus on shareholder value is lessened, as shareholders must cooperate with other stakeholders, including labor, the general public, and the state, thereby situating those systems somewhere between market capitalism and socialist capitalism.

Market socialist hybrid banking as it exists today is the result of the past two decades of financial reform that have brought about a "night and day" transformation in the quality of China's banks. Although there are valid criticisms that China's banks still do not efficiently allocate capital, nonetheless it is unlikely that China's spectacular economic growth over the period of financial transformation could have occurred if Chinese banks

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[5] Sujian Guo, *Chinese Politics and Governance: Power, Ideology, and Organization* (London: Routledge, 2013), 252–253.

had not played a generally positive role. From shareholders' perspective, while Western banks have been battered by a combination of bad debt and scandals since 2007, Chinese banks have thrived, growing rapidly in size, profitability, and adequacy of capital and provisions. They have also been responsive to national economic policy directions, thereby playing the role that the government expects of them in supporting the real economy and national infrastructure development.

The timing of China's bank transformation was fortuitous. Bankers know that "It is easy to lend money in the good times; good bankers are the ones who get repaid in the bad times." China's economy was booming. Furthermore, to ensure that banks restored profitability and stability after the debacle of the 1990s, China effectively protected and subsidized banks through interest rate repression (government policy keeping interest rates at below market rates, penalizing savers and consumers, and subsidizing borrowers and investors), through implicit guarantees of state-owned enterprise (SOE) debt, and through intervention to prevent troubled industries from defaulting on their bank debt. China's banks transformed in a short period of years that coincided with the highest sustained economic growth rates of any major economy in world history, and bank assets grew at very high rates by lending into what was a low-risk economic environment. The timing could not have been better, for both the financial sector and the real economy. The real economy could not have taken off so rapidly without a functioning banking system, and the banking system could not have performed so robustly in the absence of a booming economy.

China is now commencing a wrenching transition to what is called the New Normal, which involves structural rebalancing and a deceleration of growth. New growth targets of around 6.5% are still high compared with performance of the rest of the world, but the deceleration from successive years of growth at the rate of 10% and higher, and the accompanying structural rebalancing of the economy, are shocks to the economy, which inevitably will entail considerable adjustment on the part of businesses and perhaps a certain amount of Schumpeterian destruction. Some industries, no longer competitive, will decline, to be replaced by newly emerging industries. Some firms will no longer be profitable and will either go under or reinvent themselves in new, more competitive guise. Moreover, the government, the banks, and business enterprises of China have over the past two decades of hyper growth learned to manage under boom conditions. They lack the experience of managing in an environment of decelerating economic growth. Nonetheless, notwithstanding the complex challenges, if the competence of China's management of the economy over the past few years is any guide, it is likely that the government will be able to guide the economic transition in ways that mitigate problems while opening new avenues for renewed vigorous economic growth.

How banks fare in this less benign economic environment will tell the tale of how robust the bank management systems put in place over the past two decades really are and how well the banks have calibrated the risk/reward trade-off on their loan portfolios. Only in the bad times is the quality of banks truly put to the test. Furthermore, many of the supports and protections previously provided by the government to the banks as they developed their management capabilities are now being bit by bit withdrawn. The hybrid nature of China's banks, with strong state ownership and guidance, will to a certain extent shield banks from the full brunt of the transition. Over the next few years, not only will the quality of banks be tested by adverse economic winds, but also the reforms of the financial system will be ongoing. As China's venerable economic thinker Li Yining recently wrote, referring to the economy as a whole, and reflecting the pragmatic flexibility of China's mainstream economists:

> Structural adjustment is not bounded by limits. Following the advances of science and technology, following changes in the domestic and international situations, and following the growth in management experience and rise of executives' managerial quality, today's structural optimization only represents optimization for the present stage, and cannot represent the future ongoing structural adjustment. From this perspective, structural adjustment is relative, so structural adjustment will continue.[6]

As China's economy grows and changes, new challenges will appear, and in response new development objectives will rise to the top of the agenda: greater efficiency of capital allocation, reduction of income and wealth inequality, cleaning up the natural environment, urbanization, and a host of other reform items. In each of these areas, banks will be expected to play a role. China's modernization and the strengthening of its banking system is a major achievement, but the development of bank capabilities and evolution of the financial system, of which banks are a part, is an ongoing story. Li Yining said that in the economy "structural adjustment will continue," so in the banking system evolution will be ongoing to meet new situations and new challenges. A few key aspects of the likely path of evolution can be discerned now with reasonable certainty: ongoing interest rate deregulation; "debanking"—reducing dependence of the economy on indirect finance through banks, increasing the funding role of direct finance through equity and bond markets; cautiously affording a greater role to the private sector in bank ownership; the rise of non-bank "fintechs" such as Alibaba to contest the banks for financial transaction settlement; and greater international exposure of banks.

Other aspects of the system's evolutionary path are less certain. For example, possible privatization or reduction of government shareholding in existing major state commercial banks; fostering the development of universal banking (banks offering financial services such as insurance and brokerage products); giving banks greater scope for developing derivatives business; providing a larger role for foreign banks;

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[6] Li Yining, *Chinese Economy in Dual Transition* (Hong Kong: Zhonghua Book Company, 2014), 8.

and the ultimate disposition of the non-bank financial institutions comprising today's "shadow banking system." However the system evolves, one can be certain that, barring major change in the political institutions of China, the government will retain more control over the financial system than in the United States and most European nations. China's banking is unlikely over the next few years to evolve from the hybrid model of market socialism into a market capitalist form of banking. Xi Jinping has made it clear that even though the "invisible" hand of market forces have now been officially declared by the government to be "decisive," the "visible" hand of government guidance will not be withdrawn.

As long as the national reform process maintains the dynamism of the past two decades, there are grounds for optimism about the ability of the banking system to make the necessary adjustments needed to cope with new stages of economic growth and development. Given the importance that the Chinese government accords to the financial sector, there is every reason to believe that the evolution, of which economist Li Yining writes, will be ongoing. Nonetheless, the difficulties the banking system will face in adapting to a rapidly changing economic environment, both domestically and internationally, and the challenges posed to banks by accelerating digital technology advances are formidable.

From Cashiers to Modern Banks

The extent of the banking transformation can only be fully appreciated if one recalls what Chinese banking was like from the 1950s through the 1980s. Under Mao Zedong's leadership (1949–1976), China had no need for banks. Almost all economic activity was owned, directed, and funded by the state. Within two years of the establishment of the People's Republic of China (PRC) in 1949, all the existing banks remaining from the Republican era had been wound up, leaving only one financial institution in China—the People's Bank of China (PBOC), which served for the next three decades as the bursar for government allocation of funds throughout the country. The PBOC was an accounting and cashier unit that provided the funding needed to carry out the central economic plan. Bank of China continued to exist in the form of overseas branches to handle China's foreign trade and foreign exchange requirements in jurisdictions that recognized the PRC government, such as the United Kingdom, Hong Kong, and Singapore, but had no independent domestic existence.

In 1978 Deng Xiaoping launched "Reform and Opening"—reform of a Soviet-style planned economy that had failed China as a development model and opening to the West in search of capital, technology, ideas, and institutions needed to break out of poverty. Deng was a supreme pragmatist, not wedded to any particular ideology, committed only to using whatever policies and programs would provide China with the economic stability and energy to regain national "wealth and power."

At the start of Reform and Opening, China did not know how to build a financial system or how to run banks, so it proceeded cautiously, listening to the advice of mainstream Western economic advisors such as the World Bank, the International Monetary Fund (IMF), foreign consulting firms such as Boston Consulting and A. T. Kearney, foreign commercial banks setting up training programs in China, and international audit firms such as KPMG and Price Waterhouse, to name just a few. Chinese went on study missions to learn how banking systems in other countries worked. Thousands of young Chinese brought back with them new ideas acquired studying in universities in America, Europe, Japan, and elsewhere. As with other aspects of its national development over the past three decades, so also in the financial arena, much of China's success can be attributed to the diligence, enthusiasm, and openness with which Chinese have studied global best practice and then applied what they had learned to building a new and stable Chinese banking system.

Step by step, the Mao-era monobanking system was broken up. Out of the PBOC and the Ministry of Finance were created four nationwide state banks: the Bank of China (BOC—as mentioned above, it had continued to exist overseas), the China Construction Bank (CCB), the Agricultural Bank of China (ABC), and the Industrial and Commercial Bank of China (ICBC). In the 1980s several joint stock banks were set up, mostly owned by one state entity or another, and a host of credit cooperatives and credit trusts were licensed. The big banks, however, still more closely resembled cashiers funding the remains of the planned economy than modern commercial banks. They disbursed money not based on credit analysis or efficient capital allocation, but, based on government plan, they loaned to state-owned companies, most of which were inefficient and money-losing. To compound the problem, no proper system of banking regulation yet existed.

In the mid-1990s, China's private sector was taking off, but China did not yet have a modern commercial banking system to support entrepreneurs. State banks loaned only to state companies. Moreover, banks did not understand how to manage the risks of lending. The state companies in turn did not understand how to manage their debts. Bad debts piled up on the books of the banks, estimated to reach as much as 40–50% of bank assets.

At that time, the extraordinary economic growth of China's real economy was still in its early stages. The accomplishments of the twenty years after 1978 were impressive, but China's gross domestic product (GDP) in 2000 was still only $1.2 trillion, while the United States in the same year was a $10 trillion economy.[7] China was growing rapidly but was overall still a poor country.

A combination of the high level of bad debts on bank books, the collapse of some Chinese financial institutions, and the spectacle of the Asian financial crisis devastating

[7] World Data Bank, http://databank.worldbank.org/data/views/reports/tableview.aspx, accessed May 10, 2015.

the banking systems and economies of Thailand, Korea, and Indonesia in 1997–1998 convinced China's leaders that its banking system had become a bottleneck that would hold back growth of the real economy. Thorough reform of the banking system was required. China's banks would have to become modern commercial banks.

The question was: What kind of modern commercial banks? Even among Organisation for Economic Co-operation and Development (OECD countries), which provided the models of successful financial development that China studied, there were several models, reflecting the varieties of capitalism that existed in these economies. The U.S. model was the most powerful and influential at that time, but was structurally not typical of other OECD countries' banking systems, due to the high priority given to shareholder interests in the United States, the light hand of government regulation, the high degree of independence from government, and the instability of the system over time. The U.K. system was similar to the U.S. system but was oligopolistic and had a different regulatory approach. The Japanese "coordinated capitalist system" and the German "collaborative capitalist system," which can together be described as "cooperative capitalism," offered models that saw shareholders as one among multiple stakeholders, emphasizing instead value for multiple stakeholders and according a strong guiding role to the state.

Creation of a modern banking sector had begun in 1992, when then Deputy Prime Minister Zhu Rongji took on the additional post of Governor of the PBOC, China's central bank. Zhu began to lay the groundwork for banking transformation. The transformation, however, only really picked up speed in 1998, after the twin shocks of the Asian financial crisis and the collapse of two large Chinese credit trusts and hundreds of local credit cooperatives provided the impetus for concerted and thorough overhaul of the sector and made the task urgent. Although Zhu retired from government service in 2003, when the transformation was still in early stages, he is rightly given credit for working out the strategy that was followed over the next several years.

China studied the different banking models of advanced economies, developed plans for creation of a modern Chinese banking system incorporating foreign elements suited to China's needs, and then proceeded to overhaul its banks, transforming bankrupt bank-cashiers into modern commercial banks. The focus was primarily on the four giant state banks: ICBC, CCB, BOC, and ABC. If they could be put on the right track, then the smaller banks would fall into place. Zhu's transformation strategy had three elements: first, break the planned economy cultures of the banks by converting them into corporate entities, to be managed in accordance with sound corporate governance and banking practice; second, clean up their balance sheets by stripping bad loans off bank books and housing them in asset management companies, paying for the exercise with government-backed bonds; and third, recapitalize the banks and list them on international stock exchanges, forcing them to submit to market discipline.

Listing on international securities exchanges was a brilliant move not only because it brought in fresh capital, but because it also effectively "outsourced" part of the job of forcing the bureaucratic state banks to improve efficiency, balance sheet quality, profitability, and corporate governance. To obtain approval for listing, the banks had to satisfy the listing requirements of the Hong Kong securities exchange, which were more stringent than those of the domestic exchanges. Additionally, foreign shareholders were demanding new stakeholders, registering their approval or disapproval every trading day by their purchases and sales of bank shares. Share prices became a preoccupation of bank boards and managers—a new way of keeping score.

By 2010, in the short space of just over a decade, the transformation, at least for the top tier banks, was basically complete. Assigning a date to the completion of the transformation into a modern commercial banking system is a subjective exercise. The year 2010, when the last of the four giant state banks, ABC, was listed on the Hong Kong Securities Exchange, is probably as good a cut-off point to use as any. China's lead banks had become profitable, well capitalized, well provisioned, competently managed, and technologically advanced. The main elements of modern commercial banking had been put in place in not only the four giant state banks (by then the number had changed to five, including the Bank of Communications), but also in the twelve joint stock banks. Some of the more than 100 city banks were beginning to perform credibly as well.

The building blocks of modern banking were in place, including corporate governance, proper bank accounting, profit oriented management, risk control, internal audit, information technology (IT), and acceptable retail branch service standards. Moreover, in 2003, the bank regulatory function had been spun off from the PBOC and lodged in the newly established China Bank Regulatory Commission (CBRC), headed in its first decade by the able and visionary Liu Mingkang. By 2010, the CBRC's capabilities were maturing; it had established its reputation as a competent, hands-on regulator, acknowledged by foreigners familiar with its work to be on a par in professional capability with central banks of most major countries. It differed, however, from other top-level central banks in two ways. First, it was not independent. Second, it exerted vast influence on the strategy, tactics, and daily operations of Chinese banks to an extent that would be regarded as intrusive in other banking jurisdictions.[8]

Since 2010, change has been more evolutionary than transformational. China's banks were no longer government cashiers; they had become real commercial banks undertaking financial intermediation. But, as Li Yining stated, there is no end to the adjustment process. The banking system needs to provide broader access, capital markets need to develop further to provide financial deepening, and the financial markets need to become

[8] Private communication from Frank Rokers, formerly seconded by ING to be Chief Risk Officer at Bank of Beijing.

more market driven and less administratively controlled—topics explored in later chapters of this book.

China's Banking Structure Today

China's banks today are diverse in size and type. For the purposes of this book, I have grouped the banks into three tiers. First are the seventeen tier 1 banks, which are distinguished by their size and also by the fact that they operate nationwide networks. The CBRC officially and appropriately classifies the seventeen tier 1 banks as the "major commercial banks," subdividing them into the five "large commercial banks" and the twelve joint stock banks. The tier 1 banks held 59% of total banking system assets at the end of 2014. Aside from size, the distinguishing feature of the five large commercial banks is that the state directly owns a majority shareholding in each of them: ICBC, CCB, BOC, ABC, and Bank of Communications. These are extremely big institutions. The largest in terms of assets is ICBC, which at the end of 2014 had total assets of $3.31 trillion, making it the largest bank by assets in the world. ICBC had 17,122 branches nationwide in China and 338 offices overseas in 41 countries on six continents. It had over 5 million corporate customers and 465 million individual customers.[9]

Smaller than the five giants, but still tier 1 major commercial banks, are the twelve joint stock banks, nine of which are majority owned through various mechanisms by the government, and three of which are owned by private shareholders. Of these seventeen tier 1 banks, the big five large commercial banks and eight of the twelve joint stock banks are listed on the Shanghai, Shenzhen, or Hong Kong stock exchanges. Some are listed on more than one exchange.

Tier 2 banks are the 145 city banks, which are mostly owned by provincial and local governments and generally are restricted to operating in their base areas. Only three of these are listed on domestic securities exchanges, and one on the Hong Kong exchange. Although city banks only comprised 10% of total banking system assets at the end of 2014, some of the city banks rival the tier 1 banks in quality. Others are in need of considerable improvement in governance, management, and operations. They tend to be more susceptible to influence from local governments than are the national banks, as local governments are often significant shareholders or can influence the banks through local power networks.

Tier 3 banks are localized and special purpose institutions that number in the thousands and break down into several different license categories, including rural credit cooperatives, town and village banks, small loan companies, the state-owned Postal Savings Bank, and several others. Many in number, their quality varies greatly, but altogether they only account for 19% of total banking system assets. Their significance lies in

[9] ICBC 2014 Annual Report, Chinese version, 23–24, 149, and 152.

the creative role that they play in deepening financial access for farmers, small businesses and consumers, especially in remote areas not well served by big bank branches.

There are three large government-owned special purpose policy banks: China Development Bank, China Agricultural Development Bank, and Export-Import Bank of China. They are state-owned, play important roles in the financial system of China, and their assets (comprising 9% of the total banking system assets) are included in official measurements of the total banking system size. They are not listed on securities exchanges and do not take deposits. They rely on bond issues and the government budget for funding. Except to the extent that they play a role in China's international financial strategy, these three special purpose banks are not covered in the discussion of commercial banking in this book, as each of them represents a special situation quite different from the rest of the commercial banking sector that is the subject of this book. They are not included in this book's classification of the three tiers of the banking system but are included for purposes of computation of the assets and liabilities of the entire banking system.

Accounting for only 2% of China's banking assets, the foreign branches nonetheless play an important role in the overall system (described in Chapter 9).

Among major financial systems around the world, some rely for funding of the economy principally on direct financing through the equity and debt markets. The United States is the exemplar of this model. Others such as Germany and Japan rely to a much greater extent on indirect finance—bank credit extension. China, however, is an outlier in its extreme reliance on bank funding, accounting for 67% of total economic funding at the end of 2011. This reflects the underdevelopment of non-bank sectors of China's financial markets—equity markets, bond markets, venture capital, and insurance are all relatively small portions of total funding compared with other countries. Having acknowledged the underdevelopment and the need for development of direct finance, it is interesting to note that China's reliance in 2011 on bank funding at 67% is not significantly higher than that of Germany. As in many aspects of financial system structure, the United States is as much the outlier on one side as China is on the other.[10]

Fragile and Facing Collapse?

For anyone following the financial press accounts of banking in China today, my assessment of Chinese banking as a transformed system may arouse skepticism. The consensus view from most foreign observers in the media and in the investment analysis world is that Chinese banks' reported numbers conceal a multitude of problems that will lead to a repeat of the banking crisis of the 1990s.

[10] Silvia Iorgova and Yinqiu Liu, "Structure of the Banking Sector and Implications for Financial Stability," in *China's Road to Greater Financial Stability: Some Policy Perspectives*, eds. Udaibir S. Das, Jonathan Fletchter, and Tao Sun (Washington, DC: International Monetary Fund, 2013), 124.

Many well-educated, highly motivated, and generously compensated analysts in prestigious Western investment and brokerage firms follow Chinese banking developments in great detail, sitting in their offices in Shanghai, Hong Kong, Singapore, New York, and elsewhere around the globe, poring through financial reports, estimating the potential for bad loans that might arise from sectors of the economy that appear distressed or overleveraged. Some write of Chinese banks as compliant tools of Party bosses, lending as ordered from above, going on credit binges, lacking transparency, sclerotic in corporate culture, and grossly underreporting bad loans.

Analysts regularly forecast the coming collapse of the banking system, bringing down with it the entire economy. The first of the China banking skeptics was Gordon G. Chang, who in 2001, in *The Coming Collapse of China*, made dire predictions about the financial sector, oblivious to the transformation of the banks that Zhu Rongji was then getting underway. More than a decade later, in May 2012, a Bloomberg correspondent wrote that the capital of China's big banks was overstated because bad debts had been disguised as receivables from the central government. The correspondent further maintained that not recognizing accumulating bad debts meant that "[b]y the time any big problems show up in the banks' numbers, the jig will be up."[11]

Perhaps the most well known of the banking skeptics has been Charlene Chu, formerly of Fitch Ratings, who for years has attracted widespread attention for her forecasts of forthcoming banking distress. In February 2014, in an interview with the United Kingdom's *The Telegraph*, she explained that "[t]he banking sector has extended $14 trillion to $15 trillion in the span of five years. There's no way that we are not going to have massive problems in China."[12] Well grounded in the numbers and in quantitative analysis, her warnings represent a plausible point of view. Over the years, subsequent events have not unfolded as she had predicted, although perhaps she would retort that the day of reckoning has simply been put off. Press reports of her carefully qualified forecasts often exaggerate them with lurid headlines predicting imminent collapse of China's finances, leaving a more negative impression with the casual reader than Chu may have intended.

Widespread skepticism has led to low ratings of Chinese bank shares on the Shanghai and Hong Kong securities exchanges. Based on audited and published financial results, Chinese banks have been among the most profitable, best capitalized, and most well-provisioned banks in the world, but price-earnings and price-book value ratios of Chinese bank shares are among the lowest rated of major bank shares in the world. Analysts and investors do not believe the numbers reported and at different points in time expected

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11 Jonathan Weill, "China's Big Banks Look More Like Paper Tigers," *Bloomberg View*, May 10, 2012, https://www.bloomberg.com/view/articles/2012-05-10/china-s-big-banks-look-more-like-paper-tigers, accessed 12 June 2016.

12 "The $15 Trillion Shadow over Chinese Banks," *The Telegraph*, February 1, 2014, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10611931/The-15-trillion-shadow-over-Chinese-banks.html, accessed 12 June 2016.