RECONSTRUCTING THE MICRO-FOUNDATION OF CHINA’S FINANCIAL SECTOR

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INTRODUCTION

The Chinese economy is characterized by high savings, inefficient financial intermediaries and under-utilization of economic resources. Although GDP growth has been fairly high for the past two decades, the high growth was mainly achieved through an increase of inputs (rising domestic savings and foreign investments). As clearly illustrated by the experience of East Asian countries, growth through more and more inputs is not sustainable. Thus how to raise the quality of financial intermediaries and hence resources utilization efficiency is an urgent issue facing the Chinese economy.

I. What are the inefficient financial intermediaries?

There are two broad categories of inefficient financial intermediaries: financial firms and financial markets.

Financial firms: commercial banks, credit unions, securities firms.
Financial markets: banking market and securities market (the regulatory environment).

II. What needs to be done with the financial firms?

Financial firms must be owned (at least partially owned) by individuals and not treated as government departments by the government. A class of life-time professional financial executives has to be created and run the financial firms.

If the above takes a very long time, then foreign firms should be allowed in as early as possible.

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1 China Galaxy Securities is a full-service investment bank engaged in underwriting, brokering, asset management and proprietary trading. It is the only central government supervised securities firm in China. It ranks as the largest securities firm by amount of registered equity capital, number of business offices, number of employees and brokerage transaction volumes.

2 Since they are not allowed to pass capital directly to the final users in China, insurance companies are left out in the discussion.
III. What needs to be done with the financial markets?

Regulators must be regulated by public representatives.
Laws that delineate the power and responsibility of regulators more clearly are needed.
Financial firms have to be made accountable for their actions (NPL and bad underwriting).
Glass-Stegals should be maintained in China.

IV. Who takes the lead: the real sector or the financial sector?

One may argue that the overall low efficiency of the Chinese economy is the fault of the financial sector, but the real sector. After all, if all the goods and services producers are inefficient, then no matter how the financial intermediaries allocate resources, the overall resources utilization will not be good. While this argument carries some force, it is refuted by facts.

Financial firms can at least start to cut financing to nonperforming producers. There are millions of profitable business opportunities that are not financed and numerous profitable firms that are not adequately financed.
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[Abstract: China’s high savings are poorly allocated by its financial sector. The causes include tight government control of the sector and a lack of well-functioning firms. Reforms by the Chinese government so far have not addressed the fundamental issues and only played a consolidation role. Temporally leaving the issue of government control aside, this paper outlines a realistic reform program aimed to reconstruct the micro-foundation of the financial sector by introducing a large number of self-motivated and self-disciplined financial services companies into the sector.]

1. China’s high savings are poorly allocated by the financial sector

The fact that China’s financial sector hasn’t done well in allocating the country’s resources is well known to many interested observers. But it still helps here to give some concrete evidence.

(1) **High NPL ratio in the banking sector**

The banking sector is the dominant financial intermediary. In terms of providing funds to firms, about 80% of the funds are from the banking sector. The performance of the banking sector in allocating savings largely determines the performance of the whole financial sector. Unfortunately, as measured by NPL ratio, the banking sector’s performance is dismal. My experience with China Construction Bank and China Cinda Asset Management Company shows that the NPL ratio was at least 30% at the end of 1999. What’s worse is that nobody knows exactly what the NPL ratios are for the large state owned banks, since no independent auditing of their loans has been carried out. The NPL ratios that banks report to government were compiled by the various branches whose incentives to find out and report the true status of NPL in their regions were questionable. Recently, the president of Bank of China said in public that his bank had an NPL ratio of 26%, after some 20% of the bank’s loan portfolio had been transferred to an asset management company.

(2) **ROE of listed companies are quite low**

One nice thing about the listed companies is that they have to report their performance twice a year. Since their reports are examined by the investing public and independent auditors, there are reasons to believe that the reports are more or less accurate. One measure of the performance of the securities markets, the second pillar in the financial sector, in allocating savings is to look at the weighted average ROE of all the listed companies. This was 7.8% for the year
of 2000. Since long-term (20 year) government bond is only yielding 4.2% right now, a 7.8% ROE seems not so bad. But last year was an exceptionally good year for the Chinese economy. Plus, my colleagues at the Shanghai Stock Exchange told me that about 20% of the reported earnings last year were from stock market investing by the listed companies. The stock market rose 70% last year, so most investment did very well. Excluding this 20%, average ROE of listed companies would be about 6.5%, hardly an inspiring number. But still, there are evidences suggesting that the securities markets are doing a better job than the banks in terms of allocating the country’s savings.

The macroeconomic consequence of the inefficient allocation of the nation’s savings is chronic weak domestic demand. The bulk of savings are still channeled into the state owned sector, which does not generate much income for its vast number of employees, resulting in weak consumption demand. While lending rates are low (about 6% per year) for those who can access the banking sector, it is not the case for the firms that are excluded. In Beijing’s curb market for small private firms, one year lending rate is an astonishing 18%! This means that a lot of worthy investment opportunities are not being realized, contributing to an overall weak investment demand.

One may ask that if the financial sector is so inefficient, then why the Chinese economy has been growing so fast for the past twenty years? I believe that has to do with resource mobilization and large capital inflows. China had vast unutilized resources at the beginning of the rapid development. These resources have been mobilized for development. The high GDP growth rates during the past twenty years owes a lot to foreign investment. A recent study shows that on average foreign investment has contributed 2.7% annually to the GDP growth rate during these years.\textsuperscript{i} The foreign invested companies are still largely out of the domestic financial sector and financed by foreign injection and retained profits. If they want to borrow from domestic Chinese banks, they have to obtain a guarantee from a reputable international bank, which increases their overall borrowing costs considerably. And they are only beginning to be allowed to list in the stock exchanges. While foreign investment will continue, domestic resource mobilization will soon reach its limit. So the need to enhance the efficiency of resource utilization in the Chinese economy goes without saying.

2. Causes for the inefficient financial sector

There are two main causes for the malaise in the financial sector.

(1) Pervasive government control and interference

China’s services sectors (financial, telecommunications, education, health care, etc.) are still under the government’s tight control. In the financial services sector, the control mainly takes the following forms.
a. Entry approval. The establishment of all financial services firms has to be pre-approved by the central government. Firms with primary private sponsors are either not approved or approved with crippling business restrictions. This strict approval system results in insufficient competition from foreign and private firms. The degree of competition in the financial sector is up, but firms competing with other are all government owned and controlled. They compete on a lower level.

b. Ownership control. Other than a few joint venture insurance companies, almost all financial services firms are either directly owned by governments or owned by government controlled entities. Government ownership results in the absence of real shareholder interest in the firm.

c. Management appointment. Through ownership control, government appoints the senior management of financial firms. Many people from the government with no industry experience or knowledge are appointed as senior managers. Also, too many senior managers, appointed by the government to begin with, look for promotions in the government hierarchy as their ultimate career goals.

d. Price and quantity control. For starters, the government sets all interest rates. This type of control is most vivid in the listing of new stocks. The government carefully controls the pace and price of new share listing, so as to maintain an artificially high secondary market. Distorted stock prices lead to misallocation of resources. Other more subtle quantity controls are in the banking sector. If it chooses, the government can heavily influence the amount of bank loans being extended.

e. De facto government guarantee for the liabilities of banks and insurance companies. Because the government intervenes so deeply in the financial sector, it can’t escape from its duties as the final guarantor of the financial sector. This causes a severe moral hazards problem among financial services firms (mostly banks and insurance companies).

Reasons for the controls lie deep. To start, every government wants to have resources to serve its strategic goals. In China, these goals include the SOE sector, aggregate demand management, finding positions for aging government officials, etc. Having the control over the financial sector is a convenient and less explicitly costly means to achieve the above goals. Secondly, the financial sector is linked with the interest of almost every person in the society. It is also prone to many kinds of disasters happening. So losing control of the sector is politically a very risky undertaking, particularly in China where there are already many hidden and accumulated problems in the sector. One positive result of a tight government control is that the Chinese financial service firms are not able to take up risks (such as foreign currency risk or some derivatives risks) that can lead them to a
sudden death, as occurred in some of China’s nearby countries during the Asia financial crisis.

What compounds the control problem is a dearth of financial expertise at the top of the government. The Chinese government system is a very hierarchical one. Due to the recent nature of the market economy in China, it is by definition that there isn’t much expertise of market economy at the top of the government in general and in finance in particular. Yet, all the major decisions regarding the financial sector are made by the top.

(2) Mismanagement by financial institutions

Having faulted the government for creating an inefficient financial sector, I certainly don’t think that financial firms themselves are not to blame. Mismanagement by financial firms is very much a cause for the inefficient financial sector. Instances of mismanagement include:

a. Frequent paralysis or dictatorship in decision-making. Because the government is far away, the way to make sure that management doesn’t steal from the firm is to install checks and balances within the management. This is accomplished through committee decision-making where the CEO and several deputy CEOs are all members of the committee. But both the CEO and the deputy CEOs are appointed by a higher government organ and the deputy CEOs can’t be removed from their positions by the CEO. Since each committee member has his own agenda, it is rare that the full committee can function as a coherent body. Most often there is indecision, resulting in the loss of important business opportunities. Occasionally, a strong CEO can intimidate or buy out the other committee members. He then becomes the dictator accountable to nobody. While some people argue that it is better than paralysis in business firms, dictatorship is hardly an efficient form of corporate governance.

b. Strong short-term incentives for management to expand the business and no long-term incentives to build an institution. Since senior managers are poorly paid and their incentives lie in promotion along the government ladder, short-term expansion and window dressing are prevalent. Recently, all the “big four” banks reported strong profits and significant decline of NPL during first half of 2001. But I am sure this is a reflection of the improvement of the economy as well as posturing for the big CCP 16th congress to be held next year. It takes many years’ of consistent work to build a great financial services firm. Since top management don’t benefit much from it, there is little incentive for them to do so.

c. Lack of push from senior management leads to little incentive at the
working level to take appropriate risks in their business. Finance services are all about striking a balance between return and risk. But it is not a balance easily achieved. There need a strong push from the top management and appropriate incentives for the working level to strive hard to achieve that balance. Otherwise there are either too lax standards or too few businesses get done.

d. Loan for favor. The favor can take too forms: monetary and political. Loan for favor has been a chronicle problem in the banking sector. It compromises loan quality.

e. The absence of real shareholders leads to poor allocation of capital and the underutilization of assets. A few years ago, banks and insurance companies were in every business possible: hotels and restaurants, resorts, equipment leasing, consulting, stock brokering, etc. This has been stopped. Now they are building glitzy office building with lavish offices for top managers and numerous “training centers” equipped with recreation facilities.

The above is certain not an exhaustive list of mismanagement instances. Since the government sets the overall environment for the financial sector and takes the lead in financial reform, I believe the burden of creating an efficient financial sector lies primarily with the government.

3. An assessment of the reforms so far (1995 to 2001)

The Chinese government carried many reforms in the financial sector since 1995. Several significant measures were adopted during a crucial government meeting on the financial sector in November 1997. Without touching the fundamental feature of the sector, that is government control, the reforms aim to realign control powers among different levels of government and try to consolidate the financial institutions.

(1) Centralizing government control of large banks, insurance companies and stock exchanges. Previously, management appointment power in the branches of nationwide banks and insurance companies was shared between central and provincial governments. This has been centralized. Stripping provincial governments of this power was necessary. Not only did it stopped provincial governments from meddling in the loan-making decisions of the banks and insurance companies, but also these banks and insurance companies were made into unified firms. They were no longer a collection of separate firms. This paves the way for further reforms in these large financial firms. The two stock exchanges in Shanghai and Shenzhen were formerly owned and operated by the two municipal governments. The two exchanges competed with each other for business and paid little attention to irregular trading and other business dealings. Now the two exchanges are
centralized. The present situation is still not ideal, but it should help strengthen regulation of the markets.

(2) Forcing the collectivization of urban credit unions. Numerous urban credit unions had become shaky by 1997. But prior to 1997, there had emerged many urban credit unions in the coastal regions that were in effect small private banks. Their shares were in the hands of a few private people and their business was thriving. In order to resolve the problems in the shaky credit unions and also to compensate local governments for their loss of control power over the large banks, all the credit unions, good or bad, were ordered to be merged into the so called “city cooperative banks” to be majority controlled by the local governments (after capital injection from the local governments). This indiscriminating measure destroyed fledgling healthy financial firms and only pushed the problems it tried to resolve into the future.

(3) Changing from quota to approval system in share listing. Prior to 2000, China had the most outrageous system of listing shares in the stock market: the quota system. Now in principle any company can apply for listing. Once the CSRC\textsuperscript{iii} approves its application, the company can go ahead with a listing. There is still too much government control, but it is an improvement over the quota system.

(4) Abolishing loan quota. This coincided with the slowdown of the economy and deflation, so it has had no real effect. Nevertheless, it is a needed reform.

(5) Establishing asset management companies to deal with NPL. It helps to have institutions focusing on the disposal of NPL. But the bigger issue is to stop the flow of NPL. And on that, no fundamental reforms have taken place. There is no question that the government has to bear the cost of disposing NPL, but it is still unclear when the government will do so.

(6) Instituting the separation of business model. Banks and insurance companies were stripped of their other financial services operations (mainly brokerage business) and investments in unrelated areas such as hotel and restaurants. Although against world trend, this model suits the situations in China and should be maintained since banks and insurance companies still have the incentive problem. Giving them one more toy to play can only create one more problem for the government.

In summary, the reforms so far are predominantly not forward-looking. They were meant to consolidate the financial sector and prepare it for further reforms. If no follow-up and truly market-based reforms are introduced in a timely fashion, the positive results achieved so far will be lost.

4. Reconstructing the micro-foundation of the financial sector

The micro-foundation of the financial sector is of course very much influenced by
the macro-environment set by the government. But for the moment, this article will leave the issue of government control in the financial sector aside and only concerns with the internal structure of the banking and securities sectors (also leaving aside the insurance sector).

(1) The banking sector

The purpose of reform here is to install incentive and self-discipline into the banks, so that they will do their best to seek out worthy lending opportunities. But any reform attempt in the banking sector has to face the reality that the “big four” banks (ICBC, CCB, BOC, ABC: 70-80% of the banking sector) have a lot of NPL and too many employees that they can’t shed. Otherwise, problems in the “big four” caused by a reform will force the government to stop the reform.

Specific reform measures include:

a. For the “big four”: immediately start to prepare them for domestic or international listing. After the listing, government commits itself to reduce its shares to below 50%. As mentioned above, listed companies on average perform better than unlisted companies. Market monitoring and discipline does work. In order to steer the “big four” through listing and the subsequent reduction of government shares, a much younger and professional management team has to be put in place immediately. This team will have a longer horizon. Of course, they should be given equity interest in the banks so that their own long-term interest is closely linked with the long-term prospect of the banks.

b. Expand the scale of those well-run nationwide banks (such as China Merchants Bank, China Everbright Bank and China Minsheng Bank). Most of these banks are either listed or being listed. They are newer and have far less NPL than the “big four”. Their senior managers are well paid and have much less prospects to be promoted in the government. They also have the capital and the personal talents to expand their business. The problem they face is that the majority shares are still held by government owned entities (such as SOEs). The government should begin a program of divestment by these entities immediately.

c. Allow private local banks to be established. The vast Chinese economy calls for the creation of many small and medium size local banks to serve SMEs in their respective regions. Rather than trying repeatedly to make the city cooperative banks and rural credit unions into well-functioning local banks to support SMEs, which is an impossible task, the government should change strategy and allow purely private small banks to be established.

d. After China’s WTO entry, let joint venture or foreign sole-owned banks to be established on a fast pace. China urgently needs sound banking
practice models for the domestic banks to learn from and foreign entry can best serve this purpose. Of course, how fast foreign banks are allowed in is in an important way determined by the reform of the “big four”. Otherwise, a rapid induction of foreign banks will take too much good business away from the “big four” and that will cause their collapse.

(2) The securities sector

Direct financing through the securities sector has an enormous potential in China. This has to do with high savings, a risk-taking culture and an equity deficient capital structure in most Chinese firms. Equity capital raised for Chinese firms during 2000 was RMB150 billion (USD18 billion) and will be around RMB200 billion this year. The stock market in China is much deeper than most people thought, evidenced by the recent offering of Sinopec. The total amount of subscription money reached RMB 630 billion (USD 76 billion) for an RMB 12 billion offer. In terms of new equity money raised, the Chinese stock market will be second only to the US market this year. So the securities sector in China can play a very big role in the overall financial sector. The issues in the securities sector are quite different from those in the banking sector. Unlike banks, securities companies don’t have un-funded liabilities to the general public. This makes reforms in the securities sector much easier. The biggest problem here is a lack of government expertise. Very few top decision makers really understand the securities market. Since short-term monetary incentive is already very adequate in the securities sector, at the micro level, reforms in this sector should primarily aim to create firms that care about its long-term franchise value. The present irregularities in the securities market are mainly caused by a lack of concern for franchise value of the securities and investment management firms.

Needed reforms include:

a. Government and government owned entities should divest from securities companies and investment management firms. Unlike in the banking sector, divestment by the government will not cause any confidence problem in the securities firms. When shareholders don’t care about or care very little about the long-term franchise value, it is hard to expect that senior managers will.

b. Allow all the securities firms get listed, if they wish and can. While internationally it is not absolutely necessary for securities firms to have a public listing, in China, listing has many special meanings. First, firms can increase their capital. Securities firms in China are all thinly capitalized. The largest securities firm, China Galaxy, has only RMB4.5 billion (USD540 million) in capital. Second, government can divest through the stock market. Third, management can start to acquire equity interest in the firm through options and other means. This is facilitated
by a traded stock.

c. Encourage mergers and acquisitions in the sector. With more than one hundred securities firms, the securities market is fragmented. At the same time, no firms are large enough or have adequate expertise to handle big deals (such as Sinopec) when the market becomes tough. Measures to facilitate mergers and acquisitions are very needed now. A pre-requisite for efficiency enhancing M&A to take place is that government owned shares are diluted to an insignificant level. Otherwise, non-economic considerations will get in the way.

d. Let many JV and foreign sole-owned securities and investment management companies to be established after China’s WTO entry. China should exploit the overwhelming enthusiasm of foreign firms (particularly American and European firms) to enter the securities sector. The main benefits of allowing foreign firms in are expertise and mode of competition. There are a lot of advantages that a late comer such as China can enjoy.

e. Let investment management firms play an important role in corporate governance. It goes without saying that there needs to be numerous solid corporations for the securities sector to thrive. Sound corporate governance is sourly lacking in China. The old committee decision model in corporate governance has proved to be inappropriate under the new situation. Representatives from investment management firms who own sizable shares should sit on the board and replace the members of the old committee who were sent by a higher government body. But before investment management firms can do a good job at corporate governance, they themselves have to be transformed from government-controlled entities into market institutions valuing their own franchises.

While I don’t think there is any imminent danger of a collapse of the Chinese financial sector, the efficiency of the sector is no doubt low. Given the huge importance of the sector in allocating resources, the need to reform it is obvious. The problems in the banking sector, particularly in the “big four”, seem to be quite intractable and it will take years for the sector to show some real improvement. Since increasing evidence shows that the securities sector can allocate resources better than the banking sector and have much fewer serious problems, it makes sense for the government to enlarge the role of the securities sector in China’s overall financial intermediation and focus the next round of financial reform on the securities sector.

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i During 2000, China’s two stock exchanges raised RMB150 billion equity money for firms.


iii The China Securities Regulatory Commission.

iv China’s central bank, the People’s Bank of China, reported recently that at the end of June 2001, the “big four” accounted for 86% of all outstanding loans extended by banks. But other banks are catching up. During the first half of 2001, only 70% of incremental loans were extended by the “big four”. (Reported by the China Securities News, July 31, 2001.)
To beef up its expertise, the CSRC has hired a former chairman and a current vice chairman of the Hong Kong securities regulatory body to be its chief advisor and vice chairman, respectively. Both hires were unprecedented in Chinese government history.

By July 29, 2001, 180 listed companies have reported their first half earnings, representing a 15% reporting rate. Average ROE of these 180 companies during the first half reached 5.7%. Although usually the better companies report earlier, the reported ROE so far appears to be respectable.