CHINA

BANKING

SUMMARY

China has made impressive strides over the past 20 years toward establishing a more market-based economy, but its domestic banking system is still heavily influenced by the legacy of the old planned economy. The banking system continues to channel the bulk of private savings to the state-owned sector through loans that are often politically directed. In 1994, the Chinese government converted four "specialized" banks that had dominated the domestic banking system into "commercial" banks by transferring their responsibilities for making noncommercial loans to three newly established "policy" banks. The Chinese government also passed the People's Republic of China's (PRC's) first central and commercial banking laws and has allowed new, non-state-owned banks to set up business. Creating a modern commercial banking system in China, however, will require a number of years to complete. A number of banking sector reforms have yet to be fully implemented.

All aspects of the Chinese banking system are heavily regulated. The People's Bank of China (PBOC), the central bank, sets interest rates and deposit rates, and, until January 1998, overall bank lending was controlled administratively through the credit plan. Because a large share of lending by Chinese banks has traditionally been based on noncommercial criteria, these banks have little experience with credit analysis, and their balance sheets contain many large problem loans, especially to unprofitable state-owned enterprises. Even with the abolition of the credit plan, state-owned banks will still be under considerable political pressure to extend loans to favored enterprises or industries.

China's treatment of foreign financial institutions is highly restrictive. Foreign banks are not permitted to conduct local currency (renminbi, or RMB) business except at tightly controlled levels in limited geographical areas in Shanghai and Shenzhen. They otherwise may only participate in wholesale banking in such areas as letters of credit, export credits, and commercial loan syndicates. Foreign banks may open branches and subsidiaries (joint ventures and wholly-foreign-owned), but only in 24 selected cities and special economic zones. Foreign banks are subject to several licensing restrictions. For example, the parent foreign bank applicant is required to have a minimum of US$20 billion in total assets to open a branch. The foreign branch is required to have RMB 100 million (US$12.1 million) in capital, of which 30 percent must be deposited at the PBOC. U.S. bankers complain that this substantially restricts the branch's liquidity. Banks must have had a representative office in China for at least two years to be eligible to open a branch. To open a bank subsidiary, the parent must have US$10 billion in assets. The necessary registered capital is RMB 300 million (US$36 million). U.S. bankers also note that other *de facto* conditions for issuing a license, such as a track record of "contributions to China," lack transparency and are politically motivated. The regulations of the State Administration of Foreign Exchange (SAFE) impose further burdens on U.S. banks.

DESCRIPTION OF THE MARKET

The Chinese financial system consists of policy banks, state-owned commercial banks, shareholding commercial banks, cooperative banks, finance companies, and financial trust and investment companies. The four largest state-owned banks dominate the banking sector, with about 70 percent of the assets of the banking system as of year-end 1997. A major problem in the banking sector is the large amount of nonperforming loans resulting from a legacy of directed lending to inefficient state-owned companies. Estimates by industry analysts place nonperforming loans at about 30 percent of total loans in the banking system, rendering the banking sector technically insolvent. To address this issue, three policy banks were established in 1994 to assume policy lending from the state-owned banks. The shareholding commercial banks and cooperative banks account for 7 percent and 15 percent of banking sector assets, respectively.

State-owned Commercial Banks

Each of the four major state-owned commercial banks originally concentrated on providing financial services to a specific economic sector, but in recent years these distinctions have diminished as they have broadened the scope of their business activities. Nevertheless, the Industrial and Commercial Bank of China (ICBC), the largest of these banks, still extends working capital loans primarily to state enterprises and loans to the state sector for fixed asset investment. The Agricultural Bank of China (ABC) provides financial services in rural areas. The China Construction Bank (CCB) offers medium- and long-term financing to capital construction projects, and the Bank of China (BOC) remains the PRC's main international and foreign exchange bank.

The concentration of China's financial resources in the state-owned banks has ensured that state-owned enterprises have enjoyed preferential access to formal credit. As subsidies and other government expenditures were moved off budget in the late 1980s and early 1990s, the banking system has become an increasingly important conduit for quasi-fiscal financing to the state sector. Though non-state enterprises are generally more efficient, official policies have discouraged state banks from providing them with credit in proportion to their increasing weight in the economy. For example, state bank lending to the non-state sector represented only about 35 percent of total lending by all financial institutions at the end of 1996, even though they accounted for 57 percent of total industrial output. The situation has, however, been improving as state-owned banks have been encouraged to use prudential criteria and some state-owned enterprises have been partially privatized.

Policy Banks

China established three new "policy banks" in 1994. The Import-Export Bank helps finance major trade deals, the State Development Bank funds infrastructure projects, and the Agricultural Development Bank of China funds agricultural procurement and rural development. While the

establishment of these new banks is an important reform, the large, state-owned commercial banks remain responsible for providing "working capital" loans to financially troubled state enterprises. Furthermore, a large percentage of their policy loans have not yet been transferred to the policy banks.

Shareholding Commercial Banks

There are fourteen shareholding commercial banks, of which the Bank of Communications, China Investment Bank, the CITIC Industrial Bank, and China Everbright Bank are by far the most important. The total assets of these commercial banks, some of which are collectively owned or are joint-stock enterprises, was over RMB 700 billion (US$84 billion) at the end of 1996.

Assets, Liabilities, Deposits, and Loans of Major Chinese Commercial Banks, Year-End 1996
(In billions of RMB)

	Total Assets	Total Loans	Total Liabilities	Total Deposits
ICBC	3,629.6	1,787.5	3,343.9	1,900.9
BOC	2,107.0	1,062.3	2,002.9	673.8
CCB	2,125.3	995.5	1,515.5	1,166.5
ABC	1,466.9	898.5	1,424.8	951.5
BoComm	433.5	213.4	376.2	344.4
CITIC IB	108.7	50.9	103.2	67.9
CIB	61.1	31.2	58.5	33.1
Everbright	47.1	22.6	44.9	28.7

Sources: Industrial and Commercial Bank of China (ICBC); Bank of China (BOC); China Construction Bank (CCB); Agricultural Bank of China (ABC); Bank of Communications (BoComm); China International Trust and Investment Corporation Industrial Bank (CITIC IB); China Investment Bank (CIB); and China Everbright Bank (Everbright).

Rural and Urban Credit Cooperatives

China's financial system includes a vast network of rural credit cooperatives (RCCs). There were more than 51,000 credit cooperatives as of year-end 1997, including more than 48,000 rural credit cooperatives and around 3,500 urban credit cooperatives. Rural credit cooperatives are in principle owned collectively by their depositors, but in practice they are under the guidance of the Agricultural Development Bank of China and enjoy little autonomy in management and lending decisions. RCCs

extend credit to individuals and are an important source of financing for rural township and village enterprises. China's RCCs had total assets of RMB 1.5 trillion (US$181 billion)and total liabilities of RMB 1.4 trillion (US$169 billion) as of year-end 1997. Urban cooperatives play a smaller role, with total assets of around RMB 327 billion (US$39.5 billion) and liabilities of RMB 317 billion (US$38.3 billion) as of year-end 1997. In 1997, China began to restructure the UCCs into commercial banks in some localities and into more tightly regulated cooperatives, in others. There are 34 city cooperative banks.

Nonbank Financial Institutions

Although the number of nonbank financial institutions has expanded in China in recent years, there has been an official reassessment of international trust and investment companies in 1998, and several have been closed. In 1979, the China International Trust and Investment Corporation was established to raise foreign currency funding for projects in China. With RMB 191 billion (US$23 billion) in assets at the end of 1996, it was by far the largest. Many other trust and investment companies (TICs) were set up in the years that followed at national and local levels. Their main business has been to receive government agency and enterprise trust deposits and entrusted deposits for lending to long-term government projects.

Finance companies have been formed by industrial and commercial conglomerates to facilitate intragroup financing. Leasing companies have been primarily engaged in leasing imported capital goods to export-oriented enterprises. At the end of 1997, there were 244 trust and investment companies (with assets of RMB 434 billion or US$52.4 billion), 90 securities companies (RMB 206 billion or US$24.9 billion), 72 finance companies (RMB 149 billion or US$18.0 billion), nine leasing companies, and three insurance companies in China. The nonbank financial institutions are more autonomous and profit-driven and have introduced a limited degree of competition into the financial sector.

In 1997, the PBOC authorized the licensing of group holding companies, established by foreign companies, to finance the sale of group products in local currency. However, due to a restrictive and time-consuming approval process, only one such license has been approved to date. In addition, group finance companies are required to fund their operations from deposits held by member firms, substantially limiting their ability to support sales. Chinese firms, by contrast, can create large cash balances to support their finance companies.

Market Regulation

The PBOC is the only government agency with authority to supervise, regulate, and inspect China's banks and insurance companies. The PBOC has units responsible for bank supervision at each of its branch offices at the provincial and city level, as well as at many of its county level branches. As part of its planned central bank reforms, China hopes to strengthen the PBOC's auditing staff,

especially at the headquarters level, and to enact comprehensive central and commercial banking laws that will provide a clearer legal basis for the PBOC's supervisory activities.

Under China's traditional planned economic system, the main purpose of bank regulation was to ensure that loans were made to priority sectors and bank branches adhered to the credit plan. Chinese regulators have therefore place little emphasis on prudential regulation intended to control risks and maintain the overall soundness of the financial system. Most supervisory activity is still directed at regulating the local branches of the large commercial banks, rather than at a more centralized level where systemic risks are likely to be greater. China has begun, however, to implement reforms aimed at strengthening the PBOC's ability to supervise the banking system. However, many of the new regulations have not yet been fully implemented. In 1994, the PBOC issued new supervisory guidelines requiring all banks to apply new credit control procedures designed to bring China in line with the risk-weighted capital adequacy established in the Basle Agreement. The PBOC has received National People's Congress (NPC) approval to undertake a special US$32 billion bond issue in late 1998 to re-capitalize the state-owned commercial banks and, according to the PBOC, enable them to meet the 8-percent capital-adequacy ratio of the Basle Agreement. Few outside observers, however, expect this one-time bond issue to resolve the outstanding bad debt problem.

The Chinese authorities have never allowed a bank failure and there has been only one run on deposits (a branch of China Construction Bank experienced a run on its deposits in the fourth quarter of 1997). In June 1998, the PBOC dissolved the Hainan Development Bank, a small regional bank that had accumulated large losses during a real estate development boom in the early part of the decade. ICBC was designated to carry out the liquidation of the bank. The government has also closed China Venturetech and Guangdong International Investment and Trust Company. Other such closures are anticipated over the next few years, with speculation abounding about the possible reorganization of the larger state owned banks.

All interest rates on deposits and loans are set administratively by the central government, with preferential lending rates being set to encourage various sectors of the economy. During the period of reform since 1979, real interest rates on savings deposits have generally been kept positive, encouraging a high rate of financial saving. In addition, Chinese savers have few options but to deposit their savings in Chinese banks. The result has been a significant deepening in China's financial sector. Broad money (M2) increased from just 37 percent of China's GDP in 1979 to over 122 percent in 1997.

During periods of high inflation the PBOC has introduced indexing on long-term savings deposits. From mid-1993 until early 1995, real interest rates were negative, but private savings deposits nonetheless increased at a rapid rate. Since January 1995, real interest rates have turned positive as inflation has been squeezed out of the economy. By early 1998, disinflation had set in while real lending rates hovered at 8-10 percent. The government has set small adjustment ranges for some

categories of interest rates and has pledged to widen these ranges gradually over time. Banks also use compensating balances and creative fee structures to make up for the lack of interest rate flexibility.

U.S. PRESENCE IN THE MARKET

Foreign commercial banks have established a banking presence in China through direct branches, wholly owned foreign bank subsidiaries, Sino-foreign joint venture banks, and representative offices. Chinese-owned banks based in Hong Kong (e.g., Bank of Kwangtung, Nanyang Commercial Bank) were the first foreign-registered banks to set up branches in the Shenzhen Special Economic Zone. By the end of 1997, there were 142 direct foreign branches and 275 representative offices. With assets totaling US$37.9 billion, foreign banks including a few small joint ventures, granted US$27.5 billion of loans (24.6 percent of foreign-currency and 2.7 percent of aggregate loans, respectively). They received US$4.5 billion in savings deposits, according to official Chinese statistics, some 5.5 percent of foreign currency and 0.4 percent of aggregate deposits.

Bank of America has branches in Shanghai, Guangzhou, and Beijing; Citibank has branches in Shanghai, Shenzhen, Guangzhou, and Beijing; Chase Manhattan has branches in Tianjin and Shanghai; and First National Bank of Chicago has a branch in Beijing. Bank of the Orient has a branch in Xiamen. In October 1998, Chase Manhattan filed an application to upgrade its Beijing Representative Office to a full Branch. It has been suggested that other U.S. banks may have delayed such applications for conversion, primarily because of the restrictions on local currency business. In addition, the PBOC did not seem to encourage banks to open new representative offices or branches in major markets.

Wholesale banking and trade finance are the market staples for foreign banks in China. Primarily through their branches located outside of China, U.S. banks handle letters of credit and funds transfers, arrange or participate in U.S. or other export credit programs, participate in joint ventures in commercial banking and leasing, provide financial advice for major projects, trade currency and bonds with Chinese banks, manage foreign currency funds for Chinese entities, and arrange and participate in commercial loan syndications.

Foreign currency activities permitted foreign bank branches within China include loans, deposits, discount bills, investment, remittances, guarantees, import and export settlements, transactions between foreign currencies, agency for payments against credit cards, safe deposit boxes, and credit investigation. Foreign banks generally may only accept deposits from other foreign-invested firms (e.g., joint ventures) and foreign individuals. Chinese enterprises are not allowed to make deposits at a foreign bank from which they have not received a loan. Foreign currency loans made to Chinese firms are subject to the approval of the PBOC and the State Administration of Foreign Exchange (SAFE – previously known as the State Administration of Exchange Control). Representative

offices may be established in any Chinese city open to foreigners, but may not engage in profit-making activities but often help facilitate these activities on behalf of the banks.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Foreign banks in China face substantial restrictions on the scope of their business activities. The most fundamental are: their inability to conduct business in local currency (except in the Pudong district of Shanghai), geographical restrictions on where they can establish, and restrictions that prevent Chinese firms from opening accounts at foreign banks. The general lack of regulatory transparency, common to almost all sectors of the Chinese economy, also plagues the foreign banking industry.

In 1992, China liberalized its rules regarding permissible locations for foreign branch banking. In early 1994, China agreed to expand the number of areas that would be open to foreign branch banking and to permit foreign banks to engage in renminbi business on an experimental basis. While these commitments represented welcome progress, Chinese authorities have so far only taken gradual steps to implement them. Branch openings are still heavily controlled. Nineteen cities – Shanghai, Dalian, Tianjin, Qingdao, Nanjing, Fuzhou, Guangzhou, Ningbo, Beijing, Shijiazhuang, Xi'an, Hefei, Hangzhou, Suzhou, Wuhan, Chongqing, Chengdu, Shenyang, and Kunming – and five special economic zones – Shenzhen, Zhuhai, Hainan, Xiamen, and Shantou – are now open to foreign commercial bank branches. Most foreign bank branches are in Beijing, Shanghai, Guangzhou, and Shenzhen. Investment banks are still restricted from opening branches.

Nine foreign banks, including Citibank, have qualified to engage in renminbi business in the newly developed Pudong District of Shanghai. These banks, however, are allowed to make renminbi loans in an amount not exceeding 35 percent of their total renminbi deposits, which are limited to firms registered in Shanghai and approved by SAFE. Total deposits at those banks reached only RMB 763 million (US$92 million) in mid-1998 with loans of RMB 603 million (US$73 million).

In early 1998, PBOC announced that banks authorized to engage in renminbi business in Pudong and Shenzhen would also have access to the "first tier" interbank market for renminbi. Loans in this narrow market, however, are transacted at such large lots and high spreads that they are unattractive sources of funding for U.S. banks, which are restricted from engaging in significant renminbi lending. U.S. banks report that they can meet their meager needs for renminbi funds through secondary interbank markets.

Foreign banks are subject to several licensing restrictions. To open a branch, the parent foreign bank applicant is required to have a minimum of US$20 billion in total assets. A minimum of US$10 billion in total assets is required to open a bank subsidiary. The foreign branch is required to have RMB 100 million (US$12.1 million) in capital, of which 30 percent must be deposited in an interest-

bearing account with the PBOC. U.S. bankers complain that this substantially restricts the branch's liquidity. Foreign banks must have had a representative office in China for at least two years to be eligible to open a branch. U.S. bankers complain that other *de facto* conditions for issuing a license, such as a track record of "contributions to China," lack transparency and are politically motivated.

To obtain approval for a local currency license in the Pudong section of Shanghai, a foreign bank branch must have been a branch for three years and have been profitable for two successive years. In addition, it must have maintained a minimum average month-end balance of at least US$150 million in outstanding foreign exchange loans (US$100 million for a joint venture or wholly foreign-owned bank). A successful applicant must increase its capital by a minimum of RMB 30 million (US$3.6 million). Local currency liabilities, however, may not exceed 35 percent of total foreign exchange liabilities.

Staffing is another critical issue, especially for the representative office of U.S. banks. While branch offices can recruit directly, representative offices must hire through a Chinese government agency, FESCO, that retains 55 percent of the annual gross salary paid to a Chinese employee as a fee. This inhibits the recruiting of highly qualified employees and increases the salary cost of representative offices, because they routinely have to provide additional compensation to employees.

The regulations of the SAFE impose further burdens on U.S. banks. Since U.S. banks' business scope in China is restricted to foreign exchange business, the SAFE approval is required for almost all of their activities. Particularly troublesome is that the SAFE informs joint ventures that their accounts with foreign banks are initially approved for only two years on a renewable basis. While renewals never seem to be a problem, the uncertainty may lead many joint ventures to open accounts instead with Chinese commercial banks, whose SAFE approvals seem not to require renewal. Once a joint venture obtains approval from the SAFE, it is free to open as many foreign exchange accounts with Chinese banks as it chooses, but it must receive a specific SAFE approval for each account opened at any foreign bank. Beginning in mid-1998, the Asian financial crisis prompted the Chinese government to tighten SAFE regulations and make it difficult to issue stand-by letters of credit or other guarantees to support local currency loans from Chinese banks. Finance officers from U.S. firms complain that these regulations restrict their ability to adjust to market conditions.

Recent tightening of enforcement of foreign exchange control regulations has resulted in an increase of late payments by Chinese banks under their letters of credit in violation of UCC 500 rules. New requirements that Chinese companies financing imports through letters of credit deal only with a bank in the city where they are domiciled in order to facilitate SAFE's efforts to fight fraud seriously disadvantage the trade finance business of foreign bank branches, which typically serve a wide geographic area.

Foreign banks may become members of China's Foreign Exchange Trading Centers. While they may buy and sell foreign exchange on behalf of joint ventures, they are prevented from selling foreign exchange to Chinese customers, placing them at a considerable competitive disadvantage.

Financial Policy Discussions

The U.S. Treasury Department is actively seeking an expanded role for foreign financial institutions in China, in the context of an ongoing bilateral dialogue and in the context of China's bid to join the WTO, the successor to the GATT. As described above, the scope of permissible activities for foreign bank branches in China is very limited. The U.S. Treasury Department has been pressing the Chinese government to allow foreign financial institutions to establish in additional cities, to engage in local currency business, and to serve Chinese clients and to expand the number of areas open to foreign branch banking and to permit foreign banks to engage in renminbi business on an experimental basis. Yet, the Chinese authorities have taken only incremental steps toward market opening. The total assets of foreign banks in China have quintupled from the end of 1993 to the end of 1997, but much of this expansion could have been achieved without the presence of full-fledged bank branches in China. Indeed, many banks service their operations in China from offshore.

In 1998, China's application to enter the WTO and its financial services offer came under intense review. The U.S. Treasury Department asked China to make commitments to provide substantially full market access and national treatment for foreign financial institutions. These objectives could be achieved in accordance with a timetable for implementation of specific liberalizing measures, including previous commitments made as early as January 1994 and reiterated in meetings of the Joint Economic Committee with Secretary Rubin in 1997 and 1998.

The single most important area for improvement in national treatment is in the expansion of local currency or renminbi business. The U.S. Treasury Department has recommended that China designate an overall cap on assets or market share for foreign financial institutions rather than geographical limitations having little practical significance. The U.S. Treasury Department has also argued, unsuccessfully to date, that allowing foreign financial institutions to compete equally for local currency loans and deposits could be accomplished without opening China's borders to the kinds of capital flows that have marked the current regional financial crisis.

Exchange Rates Used:

June 1998	8.28 RMB/US$
1997 end-of-period	8.28 RMB/US$
1996 end-of-period	8.30 RMB/US$