Root and branch - China's banks

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Reforming China's banks

China is serious about sprucing up its sickly banks. The battle for modernisation will be won or lost in the local branches

AN ODD hush hangs over the soaring glass and steel headquarters of the Bank of China (BoC) in Beijing. The silence is deceptive. Although the lobby is empty, the meeting rooms are overflowing and the faces inside those rooms are drawn. China's second-largest bank is in turmoil.

But it is in turmoil out of choice. China's banks have been mere conduits for pouring money into local governments and state-owned companies, with little regard for risk or profit. That must change, say the country's political leaders, bank regulators and bankers. A sign that more heed must be paid to the market came on October 28th. That day the central bank raised interest rates for the first time in nine years. But it did more. It also lifted the ceiling on commercial loan rates, allowing banks to charge more to riskier borrowers.

By the end of the year, explains Zhu Min, head of restructuring and listing at BoC, more than 2,000 people at BoC's head office must reapply for their jobs. Eventually all 230,000 employees at over 11,000 branches will follow. Only a handful will be fired, but the point, says Mr Zhu, is really to change the way the bank lends, “and that means changing its culture”.

It matters a lot whether Mr Zhu, a former World Bank official, succeeds. Because China's capital markets are underdeveloped, the domestic economy depends on bank loans: bank assets comprise 77% of all financial assets compared with 26% in America. But the banks, almost all state-controlled, are broken. “Breakneck growth in deposits and loans, inattention to asset quality and the build-up of non-performing loans have led to the insolvency of virtually the entire banking system,” says Stephen Harner, a consultant and a director of Hangzhou City Bank. By end-2003, outstanding loans had surged to 145% of GDP, the highest such ratio in the world. Bad debts to banks at 40% of GDP are a threat to fiscal stability.

Most Chinese bankers, particularly in local branches, cannot tell a good loan from a bad one. There has been no need to, because local managers' pay has depended on asset growth and the only regulatory constraint has been a maximum loan-to-deposit ratio of 75%. Lending lots and attracting deposits quickly have been all that counted: risk, return and capital adequacy have meant nothing.

As the economy grew explosively, this fostered corruption. City officials routinely co-opted local bank managers into financing new roads and the like. State-companies' bosses, under political pressure to create jobs, secured easy money to chase new markets. Who cared about repaying loans? David Marshall of Fitch, a credit-rating agency, estimates that local governments have illegally underwritten $100 billion in loans to bankroll favoured investment projects.

This is not lost on the China Banking Regulatory Commission (CBRC), formed last year to take over as regulator from the central bank. Its much admired head, Liu Mingkang, a former boss of BoC, rightly regards capital adequacy as critical. From 2007, all commercial banks must have capital of 8% of risk-weighted assets, an international benchmark. The CBRC is also raising risk weightings for some loans, particularly to state firms, and says that banks must make bigger, earlier provisions against bad debts. Banks that fail to comply could in theory be closed.

The banks are responding. BoC, which with China Construction Bank (CCB) is one of the two of the “big four” state banks earmarked for early restructuring and share offerings abroad, has set up credit-review and management committees, hired foreign auditors and slimmed its board from a gargantuan 69 to a svelte dozen. Mr Zhu says that half of the salaries of general managers, who used to be paid identically, are now decided by financial targets. As a result, he says, lending growth has slowed.

Mr Harner calls the new emphasis on capital “revolutionary”. Not everyone is as impressed. **Eswar Prasad**, head of the IMF's China division, believes that the CBRC lacks the resources to police reforms. Mr Marshall argues that a capital-adequacy ratio of 8% is too low for risky emerging markets. And he wonders how sharp the CBRC's teeth really are: “Could it really oppose the government and shut a bank if it meant job losses?”

Enforcing the new policies in thousands of remote branches is a monumental task. Some branches lack computers and still keep their books by hand. Local managers decide the prospects of “independent” credit-approval staff and auditors sent from head office. Corruption is rife. By the end of the year, Mr Zhu says, BoC will have “tried and penalised” 50,000 staff for fraud. Nor, frequently, is respect for numbers any better at the top of the system. Banks often keep several sets of books, so they can present the most convenient figures. Recently a senior regulator advised one foreign investor to disguise a bank's appalling capital-adequacy ratios in order to ease his takeover of it.

Because centralising loan approval is fundamental to bank reform, Mr Zhu is removing power from the county and district branches where most bad debts originate. BoC now claims that its bad-debt ratio is only 5.2%. Even if this is right, it may have more to do with rapid loan growth and a recapitalisation by the government than with improved decision-making. Across the system, the lending boom of the past three years may have already set up the next wave of bad loans, to emerge as the economy slows down.

Simply, the banks still lack the skills to run profit-minded businesses. The favoured solution among Beijing politicians and bankers is to co-opt foreign money and know-how, but without giving up control of the banks. BoC has sent scores of executives overseas to learn how real banks work. It is inviting prominent foreigners on to its board, such as Peter Cooke, formerly of the Bank of England; it is also wooing Joseph Stiglitz, a Nobel economics laureate, and Paul Volcker, former chairman of America's Federal Reserve.

Smaller lenders are attracting foreign capital. HSBC paid $1.7 billion recently for a 19.9% stake in Bank of Communications (BoCom), China's fifth-largest lender. Citigroup has bought 4.6% of Shanghai Pudong Development Bank. Newbridge Capital, an American private-equity firm, has 18% of Shenzhen Development Bank.

However, the big boys seeking overseas listings, BoC and CCB, have not yet attracted foreign strategic investors, despite clean bills of health from international auditing firms and a $45 billion government bail-out early this year which pushed their capital ratios above 8%. Mr Zhu admits doubts over asset quality are putting foreign banks off paying a likely $1 billion-2 billion for a 5-10% stake, which might bring a seat on the board but no real control.

A strong foreign influence could be a boon. Newbridge gained board control of the Shenzhen bank only because its shareholder base was unusually fragmented. But the Chinese bank may now be able to centralise its risk management and to shift to safer retail banking and mortgages. BoCom's tie-up with HSBC should help it introduce more sophisticated products from credit cards to insurance policies.

At the big four, several big international banks are possible buyers of small stakes. Citigroup, advising CCB on its flotation, may take a 5-6% stake in its client. BoC's Mr Zhu says he will be able to name investors soon. But no purchases are likely to be big enough to affect the banks' strategies.

Without the reassurance of strategic foreign investors, international institutions may be wary of next year's planned $5 billion-10 billion flotations of CCB and BoC. That would mean less capital to finance reforms and to cover any fresh bad loans. It could also thwart a listing of Industrial & Commercial Bank of China, another of the big four, which is in line for a $40 billion state handout soon. Time is running out. The banks are not ready for a listing, yet need capital fast. Meanwhile, reform is hastily being grafted on to a vast, still-primitive industry. A failed banking reform is the last thing China needs.