The State and the Banking Sector in China

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Abstract: China's banking sector is suffering from bad lending practices, corruption, and large amounts of non-performing loans. This paper aims to broadly assess the extent to which the state's influence on banks create or exacerbate these problems. A reduction in the influence of the state in the banks is recommended on all levels, whether in forming goals, implementing business decisions, or hiring banking officials. It is assessed whether the health of the sector can be aided by tightening Chinese banking legislation, with particular reference to the People's Bank of China Law 2003. This option is compared briefly with the vague notion of implementing an ethical code, which is often recommended in popular financial ethics literature.

John R. Boatright[1] broadly outlines four means for a state to ensure its banks operate correctly: government regulation, market forces, institutional design, and ethics or morality.

Suggestions to improve the Chinese banking sector in each of these areas are often tied with concerns of the state's involvement in banks[2] [3] [4] – both in the central bank (the People's Bank of China) and the four largest Chinese banks (collectively referred to as the 'big four') that dominate the sector. This paper aims to broadly assess the extent to which peculiarities of Chinese legislation, regarding the state's potential influence on banks, creates or exacerbates the problems currently faced by China's banking sector, and how reducing the influence of the state on the banks improve the health and performance of the Chinese banking sector.

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1 John R. Boatright, 'Trust and Integrity in Banking', *Ethical Perspectives*, vol. 18, no. 4, 2011, pp. 473-489

2 Gamble, William, 'Going Bust', *Harvard International Review,* vol. 25, no. 2, Summer 2003, pp. 54

3 Li, Jiatao & Ng, Carmen K, 'The Normalization of Deviant Organizational Practices:The Non-performing Loans Problem in China', *Journal of Business Ethics*, 114, 2013, pp. 643-653

4 Lou, J, *China's Troubled Bank Loans: Workout and Prevention*, Kluwer Law International, London, 2011

Recent History

China's banking sector has tended to open up in recent years, being more liberalized from state control and decision-making. The two most important laws facilitating this liberalization were put in place in 1995. The Law of The People's Bank of China (henceforth 1995 PBOC), enacted by the National People's Congress, concerned China's central bank, whereas The Commercial Bank Law concerned the commercial banks, including the state-owned "big four".

Prior to these laws, a huge surmounting problem for the banking sector was that lending practices resulted in the state-owned banks accumulating large amounts of non-performing loans (NPL's) – loans which, are unlikely to be paid back to the banks. In response, government-owned asset management companies were created in 1998 to deal with NPL's issued before 1996. These repackaged the NPL's into viable assets, and then sold them to investors. However, this failed to solve the problem: in 2002, NPL's still accounted for 21-26% of total lending of the big four, according to the central bank's report.[5]

Also in 1998, to counteract the deficiency in capital of the state-owned banks, efforts were put in place by the Ministry of Finance to recapitalize the big four, by issuing Renmenbi 270 billion of special government bonds.[6] The Chinese Banking Regulatory Commission was set up in 2003 to separate banking regulation from the Central Bank and into an independent body (which called for amendments to the 1995 laws, to redefine the functions of the central bank).

Another important problem in the banking sector is corruption among bank employees in managerial positions. In one high profile case, Xu Chaofan and Xu Guojun, senior managers of Kaiping City Branch and the Bank of China, stole $483 million in a loan scandal.[7] The Washington Post story paints a picture of the state of the banks that allowed such an embezzlement to take place[8]:

> The men allegedly were able to avoid detection for years because the bank invested branch managers with unusual authority, allowing the men to approve loans and asset transfers with a single signature.

[5] http://en.wikipedia.org/wiki/Banking_in_the_People's_Republic_of_China from

[6] Zhou, Zhongfei, *Banking Laws in China*, Kluwer Law International, 2007

[7] http://chinascope.org/main/content/view/275/148/

[8] http://articles.washingtonpost.com/2009-05-10/world/36780916_1_bank-branch-visa-fraud-passport-fraud

This suggests there may be far more corruption among banking officials than goes noticed. The former chief of the Bank of China, Wang Xuebing, was also the culprit of a large loan scandal[9], showing that corruption is a problem even among the most senior employees of the banks.[10]

Recapitalization

The recapitalization of the banks has been criticized. It has been said[11] to undermine the bank's disincentive to take risky loans, and can foster the expectation – in both the bankers and their customers – that recapitalization might happen again. Also, it fails to duly punish the bank and its employees who lent irresponsibly, leaving them to potentially make the same mistakes with no retribution.

This problem might be supposed to have its root in the relationship between the state and the banks. Zhou writes[12]:

> The Chinese government continued to use the public funds to recapitalize state-owned banks with the belief that, as the owner of state-owned banks, it had a duty to inject funds into them and that it became impossible for state-owned banks themselves to use their own profits to raise the capital level due to their huge amount of non-performing assets.

However, it would still be in the interest of the government to have recapitalized the banks even if they were not state-owned. (We see parallels here with 'too-big-to-fail' privatized banks being recapitalized in the west, around the time of the 2008 financial crisis.) At any rate, complete lack of state involvement in the bank's finances is by no means the best solution to the capital adequacy of the banks and the loan problem, and has even been described as the "worst-case scenario"[13] by Moody's Investor's Service, who say that, worse than being ineffective, it has the potential to "erode the sector's credibility – banks and regulators alike – and undermine investor confidence". Our concern is that there are specific ways in which the banks are dependent on the state – perhaps ways which are not ruled out by effective legislation, and of which we see the effects – which have a negative impact on lending practices and the health of China's financial sector. But by no means is the recommendation to completely oust government involvement in the banks.

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[9] http://www.businessweek.com/stories/2002-01-27/chinas-banks-under-a-cloud

[10] Gamble, William, 'Going Bust', *Harvard International Review,* vol. 25, no. 2, Summer 2003, pp. 54

[11] Zhou, Zhongfei, *Banking Laws in China*, Kluwer Law International, 2007

[12] Zhou, Zhongfei, *Banking Laws in China*, Kluwer Law International, 2007

[13] http://www.institutionalinvestorchina.com/arfy/uploads/soft/110708/1_1126435151.pdf

The People's Bank of China

Largely following Zhou[14], we shall assess the independence of the state bank, with recourse to the aforementioned legislation put in place, namely the 1995 and 2003 PBOC laws. In the literature regarding independence of state banks, a major worry is that political interference may drive monetary policy, particularly in order to appease the public with favourable interest rates.[15] We shall take for granted in this paper that state involvement in a central bank involves the fear, as Zhou[16] puts it, that:

> …government focuses on short-term economic growth and has strong incentives for monetary expansions. It would be beneficial to the public if monetary authority was delegated to an independent central bank not subject to elections and that cares more about the future.

Is it likely that the state's influence, bound and unbound by standing legislation, will reify these fears?

The 2003 PBOC law states that the state bank is delegated to carry out monetary policy in order to maintain monetary value stability to facilitate economic growth. Though financial stability is not explicitly stated as a first priority, it is strongly suggested[17], and having this as a priority will reduce the capacity for political interference when decisions are considered which affect such stability.

But Article 7 of 2003 PBOC Law says that the PBOC implements monetary policy under the leadership of the state council. Though approval is needed from the state council of monetary policy decisions, this approval is not specified any further and is open to interpretation.

There are potential issues regarding 'personal independence' as well. Legislation barely prevents the state from deciding who is involved, and who is not involved, in the PBOC. In fact, it is the responsibility of the Central Committee of the Communist Party of China to appoint the state bank's governor.

Neither the 1995 nor the 2003 PBOC law explicitly states the qualification requirements for officials of the central bank, nor do they spell

14 Zhou, Zhongfei, *Banking Laws in China*, Kluwer Law International, 2007

15 http://www.becker-posner-blog.com/2010/05/should-central-banks-be-politically-independent-posner.html , also see 'Comments' section

16 Zhou, Zhongfei, *Banking Laws in China*, Kluwer Law International, 2007

17 Zhou, Zhongfei, *Banking Laws in China*, Kluwer Law International, 2007

out grounds for their dismissal. So neither law prevents an employee of the PBOC being ousted from their position on the grounds of not following orders from political authorities. Furthermore, the terms of office of the central bank officials are not stipulated by law – they can remain in power for an indefinite length – and though the 2003 PBOC law states that an official may not work anywhere else, it is not clear whether there is a punishment for doing so.

The result is that government officials are heavily involved in the monetary policy committee.

Commercial Banks

Lack of state independence of the "big four" incurs several major problems. Firstly, lack of independence of the bank to form and implement objectives in lending, along with lack of personal independence, mean that the government is able to act on its incentives for funding its own initiatives and enterprises. Li and Ng[18] write:

> State-owned enterprises and private firms both had to obtain loans from state-owned banks, and as a result of the state's personal influence, the enterprises with political connections could more easily obtain funds (Brandt and Li 2003; Firth et al. 2009; Ge and Qiu 2007).

The problem of non-performing loans has been partly blamed on this lack of independence, because, as with the central bank, conflicts of interest with the state mean that it is more difficult to carry out the bank's primary functions regarding lending, and "credit risk and business prospects" [19] may be weighed against *guanxi* (political connections).

State-owned enterprises and initiatives with government backing are "the principle recipients of loans from the four main state banks" [20], so the scale of this problem is not negligible. The figures are worrying:

> Last year alone, a total of 8.2 trillion yuan (US$1.33 trillion) was provided to A-share listed companies in 2012. Among the top 50 companies securing the highest number of loans, 43 were state-run enterprises and only two were private firms. But

[18] Li, Jiatao & Ng, Carmen K, 'The Normalization of Deviant Organizational Practices:The Non-performing Loans Problem in China', *Journal of Business Ethics*, 114, 2013, pp. 643-653

[19] Gamble, William, 'Going Bust', *Harvard International Review,* vol. 25, no. 2, Summer 2003, pp. 54

[20] Gamble, William, 'Going Bust', *Harvard International Review,* vol. 25, no. 2, Summer 2003, pp. 54

> the concentration of financial resources among state-run companies has not translated into growing revenue. Among the top ten loss-making public firms in China, state-run companies accounted for half, with the top four being China Ocean Service, Aluminum Corporation of China, Metallurgical Corporation of China, and Angang Steel Company. [21]

The reported total loss of the big four in 2012 was Renmenbi 28.9 billion. [22] Further evidence shows the bank's policies favouring such state-backed initiatives, presumably regardless of their credit risk:

> Statistics showed that in the eastern province of Zhejiang, the interest rates for small loans stood at 20%, while larger companies usually obtained loans with a 10% interest rate, compared with the 5.3% interest rate for state-run companies.[23]

Apart from lending practices, there are two major problems resulting from lack of personal independence of commercial banks. The first is, unsurprisingly, corruption: if the bank's financial success and performance does not dictate the employment of its managers, as is likely if the state has a say in who is in charge, then this may allow for managers to continually financially damage the banks for personal gain, perhaps without repercussion. Secondly, if people are hired because of their connections rather than their abilities at banking, this does not ensure the workers are responsible, ethical, and qualified to be involved in banking.

This second point stands regardless of whether there is a better pool of bankers lying around.[24] The ones who are better at their jobs, regardless of their connections, would be better-placed by a more meritocratic system to make decisions for the bank, and furthermore, this would incentivize people to be better at their jobs.

Legislation, particularly the Commercial Bank Law 2003, is making some efforts in handling the detrimental state-involvement in the big four, but does not to my knowledge explicitly outline state involvement as a problem. As mentioned, the Chinese Banking Regulatory Commission was set up as an independent body in charge of banking regulation. Though its personal independence is questionable (the current CBRC president Shang Fulin is also

[21] http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20130530000024&cid=1102
[22] http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20130530000024&cid=1102
[23] http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20130530000024&cid=1102
[24] Koslowski, Peter, *The Ethics of Banking: Conclusions from the Financial Crisis*, transl. Deborah Shannon, Issues in Business Ethics vol.30, Springer, 2011

a member of the Central Committee[25]), it does aim to implement strategies to successfully target the problems addressed, e.g.[26 27]

> (3) to strengthen the risk management pertaining to credit extension to business group clients and effectively control the loan concentration and risks associated with connected lending. In this respect, the CBRC is going to issue the rules governing the monitoring of credit risk concentration and connected lending at commercial banks.

(For problems with this aim, regarding connected lending, credit concentration and the concept of a single borrower, see Zhou[28].)

> (4) to underpin the synergy of credit policies and industrial policies and optimise the sector distribution of bank loans. In this respect, banks are required to properly control their loans to sectors such as steel, aluminium, cement, real estate and auto industry, while encourage loans to infrastructure and public facilities construction projects.

Ethics and Morality

Turning back to the four broad means of keeping banks in order, addressed at the beginning of this paper, it has been suggested that the implementation of ethical codes in banking, both in general[29] and in China[30], can resolve many of the problems we have been discussing.

Though ethical codes, especially those focussed on trust, integrity and transparency, are important for the banking industry – and perhaps more so compared to other industries, due to requiring fiduciary duties as opposed to contracts in some situations[31], or the fact that the good traded and the service

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25 http://en.wikipedia.org/wiki/Shang_Fulin

26 http://www.cbrc.gov.cn/EngdocView.do?docID=610

27 http://www.cbrc.gov.cn/showyjhjjindex.do

28 Zhou, Zhongfei, *Banking Laws in China*, Kluwer Law International, 2007, chapter 'Risk Based Regulation', pp.85

29 Green, C.F., 'Business Ethics in Banking, *Journal of Business Ethics,* Volume 8, Issue 8, August 1989, pp. 631-634

30 Li, Jiatao & Ng, Carmen K, 'The Normalization of Deviant Organizational Practices:The Non-performing Loans Problem in China', *Journal of Business Ethics*, 114, 2013, pp. 643-653

31 John R. Boatright, 'Trust and Integrity in Banking', *Ethical Perspectives*, vol. 18, no. 4, 2011, pp. 473-489

of banking are intangible and hard to assess[32] – I share Boatright's pessimism that ethics are hard to implement, and fragile even when implemented. [33]

Specifically regarding China, there are strong suggestions from the literature, for example from Kirk O. Hanson and Stephan Rothlin[34], that the prevailing ethical code can foster problems of corruption and bad lending:

> Company leaders tend to be given the status of benevolent dictators who are accountable to no one. The way up to the top positions in many organizations may be paved more by one's ability to flatter a senior person at the right moment than by one's competency."
> "[…]family bonds remain the strongest social reference, as also reflected strongly in the Confucian tradition. Thus, doing business with family members is often preferred to conducting arms-length transactions.

It seems as though, even if these generalized claims do have any strong basis, the right approach to their effects is through legislation, rather than to declare an upheaval of an ethical code ingrained in the culture of an institution. For example, this ethical explanation can account for the norm that "Loans are not always documented. Collateral is not requested."[35] But these problems can just be enforced in legislation. Gamble claims the problem of documentation arises because "state banks lend to state companies, so there are often no records, collateral, mortgages or security interest." [36] So a change in the relationship between the state and the commercial banks will facilitate the practice of documentation, and plausibly more readily than simply a change in ethical code.

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[32] Koslowski, Peter, *The Ethics of Banking: Conclusions from the Financial Crisis*, transl. Deborah Shannon, Issues in Business Ethics vol.30, Springer, 2011

[33] John R. Boatright, 'Trust and Integrity in Banking', *Ethical Perspectives*, vol. 18, no. 4, 2011, pp. 473-489

[34] O. Hanson, Kirk & Rothlin, Stephan, 'Taking Your Code to China', *Journal of International Business Ethics*, vol.3, no.1, 2010, section: 'Special Reasons Why Operating in China is Harder'

[35] Gamble, William, 'Going Bust', *Harvard International Review,* vol. 25, no. 2, Summer 2003, pp. 54

[36] Gamble, William, 'Going Bust', *Harvard International Review,* vol. 25, no. 2, Summer 2003, pp. 54