Banking in China: Are New Tigers Supplanting Old Mammoths?

by

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Abstract

In spite of China’s economic success, the continued involvement of the government creates severe agency problems, particularly through the sick relationship between State Owned Enterprises (SOEs) and State Owned Commercial Banks (the four “Old Mammoths” with a market share of almost 2/3). Here, gradual transition didn’t fasten adequate structural adjustment thus loading unbearable amounts of NPLs at banks. According to independent estimates this poses potential macroeconomic threats to China. Political interference in the banking sector should be severed. We argue that ownership diversification is an effective first step to improve the corporate governance of banks in China (with the long-term goal of cutting government ownership of banks), a necessary move to bring better banking to China, where the country size suggests that foreign banks can only play an ancillary role.

Indeed, we show that a layer of newly bred banks (Joint Equity Commercial Banks and City Commercial Banks), the “New Tigers”, is rapidly expanding and exhibits better performance than the Old Mammoths. While the latter have the state as the sole owner, the New Tigers (even though they are not private banks) have a plurality of shareholders (“Diversified Ownership”), possibly allowing them to have better corporate governance. There is, however, a second distinctive trait: most of the New Tigers concentrate their business in China’s affluent Eastern coast, while the Old Mammoths operate across the whole of China. Then, is the better performance of the New Tigers due to better corporate governance or instead to the fact that most of them operate in a favorable environment?

To answer this question, we run a field survey on 20 City Commercial Banks (CCBs) located in three provinces with different level of economic development. Since all CCBs have similar “Diversified Ownership”, this exercise allows us to assess whether the secret behind the success of the New Tigers is geography rather than better corporate governance.

We find that Eastern CCBs enjoy a much better performance than Western CCBs. Thus, we conclude that geography is a key factor behind the success of the New Tigers, and it is not clear whether they will be able to bring better banking to the whole of China. A policy implication of this is that reforms improving the functioning of the Old Mammoths are needed as well to upgrade banking across China. Otherwise, should better banking materialize in the most developed areas only, this would further deepen economic disparities across China.

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Keywords: China; State Ownership of Banks; Corporate Governance

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I. Introduction: Why China needs better banking

On Friday April 22
nd 2005 the Chinese government intervened with 15 billion dollars to save the Industrial and Construction Bank of China (ICBC), the largest bank of the country, in a liquidity crisis. Such intervention followed the injection, at the end of 2003, of 22.5 billion dollars in support of other two state owned banks: Bank of China and China Construction Bank.

Why is there a banking crisis in an economy which has been growing at an average rate of 9% over the last 25 years? Usually, we expect a banking crisis to happen when the entire economy of that country suffers a crisis and the Chinese case seems a puzzle. In reality, this puzzle is only apparent, not actual. To grasp this, we need to go back to the special features of China’s transition. This helps us understand how strong growth of the economy and a banking crisis are not contradictory but the natural outcome of policy choices. Differently from the experience of most formerly planned economies and well before the others followed their “shock therapy” to the market, China opted for a gradual transition strategy. As most economists now concur, such a choice was far-sighted because it obtained two major results, not unavailable to the shock therapy: (i) it avoided the acute tensions (e.g. mass unemployment and destructive disorder of productive processes) linked to the abrupt phasing out of state enterprises; (ii) it allowed some institution building before privatizing some key sectors of the economy, where otherwise China risked moving from the problems of state ownership to those of private monopoly (Stiglitz, 2002; Black and Tarassova, 2002; Lau, Qian and Roland, 2000). The gradual transition allowed China to keep its robust growth while rooting the new domestic private economy (representing now beyond ¼ of GDP) in international production networks.

Nevertheless, there was a dark side of the coin: State Owned Enterprises (SOEs) survived the plan economy, thanks to the gradual transition, and kept making losses (Opper, 2001). The four big State Owned Banks (SOBs) took the bulk of those large SOE losses. It is now clear that the unhealthy brotherhood between SOEs and SOBs is the chief shadow on the future of China’s economic miracle. Indeed, bringing better banking to China is needed on two main grounds. First, to overcome this macroeconomic threat to continued growth coming from the potential systemic instability associated with SOBs’ fragility. Second, to deliver a much needed improvement to the allocation of loans to enterprises, thus enhancing their corporate governance. The big question is how to achieve better banking in China. A preliminary aspect concerns the role of foreign banks. Even though WTO rules will gradually allow foreign banks to acquire full operational status, we will argue that the size and complexity of the country make it very unlikely to hold that foreign banks by themselves can solve China’s banking problem. In other words, as shown by the cases of other big countries as well, foreign banks can promote competition and better banking indirectly but do not usually take a large share of the market in a big country. This implies that better banking in China has to be found at home.

In this respect, we will show that China’s banking system is not monolithic: on the side of the problematic “Old Mammoths” (so we will label the SOBs), a breed of lively “New Tigers” (Joint Stock Banks, City Commercial Banks, etc.) is rapidly emerging. These banks show clearly better performance, possibly because the state is not their single shareholder as it

1 ICBC is about ¼ of the Chinese banking system’s total assets and those 15 billion dollars represent beyond 2% of ICBC’s assets and above 1% of China’s GDP. An analogous percentage on total assets applied to 45 billion dollars in support of Bank of China and China Construction Bank, amounting to 4% of GDP. Foreign currency reserves coming from the People’s Bank of China were used for the purpose against banks’ equity. See IMF (2004) for an evaluation of the December 2003 intervention and the associated reform steps.
is for the SOBs. We will conclude that even the New Tigers will not be able by themselves to solve China’s banking problem. As we will show, part of their success seems due not so much to their better corporate governance, as much as to the fact that their business is concentrated in the Eastern belt, the most developed area of China. Thus, solving China’s banking problem goes back to dealing with the SOBs. Even though the Chinese authorities show activism to tackle the issue, the prospects may still be rather murky.

The rest of this paper is structured as follows. In Section II we start reviewing the negative impact of state ownership on the corporate governance of banks. We also discuss why the contribution of foreign banks may be only complementary to solving the deep rooted problems of China’s banks. Then, we provide details on the intense growth of the New Tigers, the new breed of Chinese banks, articulating also a performance comparison between them and the Old Mammoths (the SOBs). This leads us to ask whether the New Tigers offer China an option to growing out of its banking problem. Although extrapolating the New Tigers’ growth might lead one to answer that they are rapidly supplanting the Old Mammoths, we posit that a thoughtful answer to this question requires carefully evaluating the sources of the New Tigers’ better performance. Specifically, we need to understand whether this is caused by better corporate governance only or whether and to what extent the New Tigers are better simply because they do business in the most developed area of China, thus escaping with their location the economic frailties the SOBs have to live with. Section III is devoted to shed light on this issue. To accomplish this, we design a field survey able to check whether, within (a significant segment of) the New Tigers, bank performance differs depending on the economic development of the geographical area where banks do their business. This is exactly the rationale behind looking at City Commercial Banks (CCBs), one of the most vibrant segment within the New Tigers, which happens to include banks located throughout the whole of China. By focusing on 20 CCBs located in three provinces of China featuring diverse levels of economic development, we keep corporate governance (relatively) constant and can, thus, ascribe any significant difference in performance across the provinces to their relative underlying prosperity. After describing the structure of our survey, we show its main results confirming that CCBs’ performance is systematically and positively related to the level of economic prosperity in their province. This sheds new light on our main point. Furthermore, the richness of the information obtained through the survey allows us to gain additional insight on other factors affecting bank performance in China. Finally, Section IV summarizes our main findings and discusses policy implications as well as avenues for future research.

II. Problems with the Old Mammoths and growth of the New Tigers

II.1. The negative impact of state ownership on the corporate governance of banks

While China experienced its unique economic miracle, featuring average annual growth rates of about 9% over some 25 years, not all sectors progressed at the same pace, possibly providing bottlenecks for future growth. Progress has been slowest in the service sector (Dutta, 2005). And within the service sector advancement has been most sluggish in the financial sector. In this respect, the fragility of China’s banking system has attracted much attention for two main reasons. First, because heavy bank losses seem to pose a macroeconomic threat to continued growth coming from the potential systemic instability

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2 Some of the arguments presented in this Section were already developed in Ferri (2003).
associated with the weak SOBs. Second, because China needs to improve the allocation of loans to enterprises, thus enhancing their corporate governance. Much of the issue hinges on the sick link between SOBs and SOEs. This brings us to dwell on the negative impact of state ownership on the corporate governance of banks.

Various papers by La Porta et al. (e.g., La Porta et al., 1997, 1998) analyze the nexus between institutional setup and the functioning/development of financial markets. In general, they find that the degree of investor protection is crucial in this respect: the degree of investor protection is at a minimum in countries with French origin law, while it is at a maximum in countries in the tradition of the common law (UK, USA). Obviously this introduces also the role of the state, as the state itself is always the key actor in drawing up market rules, from which investor protection derives. Indeed, the authors show that, comparing countries, as state ownership increases investor protection & financial market development decrease. Further according to Pagano and Volpin (2002) the degree of investor protection is negatively correlated with the degree of protection in the labor market. They show that “corporatist” economies (especially with coalition governments) deliver low investor protection in exchange for high labor protection while, on the contrary, in “non-corporatist” economies they find high investor protection and low labor protection. Finally, the more widespread is shareholding, the higher is the level of investor protection chosen by the government: i.e., there is a ‘lock-in’ effect of privatizations (Perotti and van Oijen, 1999). According to Rajan and Zingales (2001) choices by “interest groups” hinder financial market development, while ruling governments may oppose financial market development since, by raising competition, this limits their discretion and their power. They predict that government opposition to financial market development is lower if the economy is open to trade and to capital flows.

What is more relevant here is that in a later paper, La Porta, et al. (2002) directly address the issue of government ownership of banks. The authors maintain this is a very special case to verify the “political” theories of the distortions induced by state intervention in financial markets. Their main finding is that, again comparing countries, after state ownership of banks increases, the growth of financial markets, of per capita income and of productivity are all lowered. Thus, the general consensus in the literature is that state ownership of banks is detrimental to bank efficiency, to the development of financial markets and, through these channels, also to economic growth.

In the specifics of China various authors have shed light on the negative impact of state ownership on bank performance. We quote just a few of them. Using city-level data over the early period of 1989-1991, Wei and Wang (1997) find evidence that China’s bank loans favored state-owned industrial enterprises and argued that such lending bias diminished the effectiveness of other measures designed to promote the growth of non-state sectors or to induce SOEs to restructure. In line with this, Brandt and Li (2003) find that, that, as a result of discrimination, private firms resort to more expensive trade credits. Using Chinese provincial data from 1991 to 1997, Park and Sehrt (2001) show that the financial reforms of the mid-1990s were ineffective at lowering policy lending by SOBs, thus negatively impinging on these banks’ performance, while SOB lending did not respond to economic fundamentals. Moreno (2002) notices that banks in China traditionally met government policy goals by financing the operations of SOEs, regardless of their profitability or risk, that, while bank exposure to SOEs has tended to decline over time, SOEs still accounted for over one-half of outstanding bank credit in 2000 and that exposure to poor-performing SOEs has had a major impact on bank performance. Chang (2003) holds that China's (mostly unprofitable) SOEs have been kept afloat with loans from the SOCBs, while SOCBs cannot force SOEs to pay back their loans without causing their collapse and the inevitable political crisis that would ensue, hence SOBs have continued to lend to SOEs. This fact is confirmed by a survey performed by the People’s Bank of China in 2003, finding that of the total NPLs
by SOBs, 30% was due to intervention by the central and local governments, 30% resulted from mandatory credit support to SOEs, 10% arose from poor legal environment and weak law enforcement in some regions, and 10% stemmed from industrial restructuring in some enterprises, thus leaving only 20% originated by business operation and management of the SOBs themselves (Zhou, 2004a). Cull and Xu (2000) detect signs of SOB loans going more and more to unproductive SOEs during the 1990s when these banks increasingly assumed bailout responsibility (Cull and Xu, 2003). A less alarmed view is held by Gordon (2003) who argues a banking crisis might materialize in China only with free private capital movements.

Studying China’s experience with the asset management corporations (AMCs) introduced to address SOBs’ NPL problem, Ma and Fung (2002) conclude that, while posing significant quasi-fiscal liabilities, their contribution to the resolution of the NPL problem was only limited. In chorus, Bonin and Huang (2001) criticize the design of these AMCs. Less unfavorable views are held by Zhou (2004b) and also by IMF (2004).

II.2. Foreign banks cannot be the whole solution: home solution needed for better banking

Can foreign banks help bring better banking to China? Answers are generally positive, but the next issue is to what extent foreign banks can help China.

The economic literature holds that the entry of foreign banks benefits emerging economies mostly because foreign banks are likely more efficient (and more independent) than domestic banks and, thus, they foster virtuous competition for the receiving banking systems (Claessens, et al., 2001; Focarelli and Possolo, 2001; Hawkins and Milhaljek, 2001). Furthermore, it is often argued that the retail entry by foreign banks is more desirable than their wholesale entry, which might even channel to the country “hot money” and favor procyclical swings in capital inflows. And foreign bank penetration may also facilitate FDI inflows.

But what are China’s specificities in this respect? Liu (2004) argues that the sequencing in terms of entry of foreign banks adopted by China has been able to avoid some of the problems observed in other countries, where a rapid entry of foreign banks has been associated with excessively rapid growth in overall bank lending fuelling speculative excesses. Ma and McCauley (2004) show that, in spite of the fact that China’s capital account is still closed, interest rate differentials seem to affect the monthly variation in the fraction of foreign currency bank deposits. In their interpretation, this suggests that, behind the official ban on capital outflows, China’s capital account is already integrated to some extent. They also stress that the non negligible holding of US dollar deposits by Chinese nationals indicates a more internationalized banking system than conventionally thought. Studying inward FDI to two regions of China, He and Gray (2001) find that FDI to each region by non-financial corporations increase sharply following FDI to that region by commercial banks. They argue that this evidence is consistent with two explanations. First, that the newly available expertise in the international financial system allows multinational firms to invest with the assurance that they will have sophisticated capability to hedge risks. Second, that, since the financial sector is a sensitive sector, permission for multinational banks to enter is a sign of a commitment to a policy of open industrialization by that region.

In practice, foreign bank entry to China is still too recent/limited to make it possible to assess its effects. For instance, it is clearly the case that the few Chinese banks where foreign banks hold a participation are among the best performing but it is not clear whether we can draw a causal link. In other words, have these banks significantly improved their
performance after the advent of foreign participation or were they high performers already before? Furthermore, the extent to which foreign banks can play a role toward better banking in China may be limited by two additional considerations. As argued by Bonin and Huang (2002), foreign bank competition could mainly be in the form of taking away wealthy and profitable clients away from local banks, while foreign banks might shy away from building matching networks any time soon. In addition, as shown in Ferri (2003), the extent of foreign bank penetration is smaller in larger-sized countries. Arguably, this depends on the fact that even the largest banks find it unpalatable to concentrate their risks too much, something which could happen should they take a high share in a very big country.

These considerations suggest that the potential for foreign bank penetration in China should not be exaggerated. Thus, though it is reasonable to expect that foreign banks’ role will be key in various respect (from risk management, to competition, to investment banking), better banking in China has to be found at home. In this sense, considering that on the side of the problematic “Old Mammoths” (the SOBs), a breed of lively “New Tigers” (Joint Stock Banks, City Commercial Banks etc.) is quickly forming, it is important to focus on the latter.

Figure 1. Annual rate of growth of total assets: *Old Mammoths vs. New Tigers*

![Graph showing annual rate of growth of total assets: Old Mammoths vs. New Tigers](image)

Source: Our computations on data derived from Bankscope.

II.3. The *New Tigers* grow intensely and outperform the *Old Mammoths*
The New Tigers are growing very rapidly. Even though truly private commercial banks have been absent from China’s landscape, and in spite of belonging to different institutional categories, the New Tigers share a common trait distinguishing them from the SOBs: Contrary to the situation of the SOBs, which have the state as the single shareholder, the New Tigers have a plurality of shareholders. Some of these shareholders may be themselves public sector shareholders being part either of the public administration or of the SOE system, but none of them is in the position of single shareholder in any of the New Tigers. As argued elsewhere, the plurality of shareholders may be virtuous in reducing political interference in the bank’s business conduct, thus delivering better corporate governance and better performance.

Figure 2. Percentage market share of the Old Mammoths vs. the New Tigers

This conjecture is consistent with what observed over the years. Namely, the New Tigers are denting more and more SOBs’ market share, and also the former visibly outperform the latter according to the usually employed indicators. Between 1998 and 2003

\[\text{Source: Our computations on data for total assets derived from Bankscope.}\]

\[\text{3 Depending on the availability of data on Bankscope, we include in the group of the New Tigers 35 banks whose size differs greatly: Bank of Communications, China International Trust & Investment Corporation, China Merchants Bank, China Everbright Bank, China Minsheng Banking Corporation, Hua Xia Bank, Fujian Industrial Bank, Ping An Bank, Shenzhen RCCs, Bank International Ningbo, First Sino Bank, Qingdao International Bank, Business Development Bank, Chongqing Commercial Bank, Shandong International Trust & Investment Corporation, Guandong Development Bank, Shanghai Pudong Development Bank, Shenzhen Devlpmnt Bnk, Xiamen International Bank. To this Bank of Shanghai, Beijing CCB, Tianjin CCB, Shenzhen CB, Hangzhou CCB, Changsha CCB, Chengdu CCB, Jinan CCB, Nanchang CCB, Nanjing CCB, Ningbo CB, Wuhan UCB, Wuxi CCB, Xi'an CCB, Xiamen CCB, Zibo CCB. The last 16 of these 35 banks are City Commercial Banks (CCBs), the type of banks we will analyze later, while the other 19 are assorted across the other categories.}\]

\[\text{4 See, among others, Ferri (2003), Liu (2002).}\]
the average annual rate of growth of total assets was 11.2% for the SOBs and 23.8% for the New Tigers and the gap became larger between the first sub-period 1997-2000 (12.3 against 20.4%) and the second one 2000-2003 (10.0 against 27.2%; Figure 1). This gap produced a significant erosion in SOBs’ market share: over this period they lost 10.5% of the market, so that the share of the New Tigers almost doubled from 12.8 to 23.3% (Figure 2).\footnote{We measure market shares here on the sum of the SOBs plus the New Tigers, thus focusing on commercial banks and excluding the postal system and policy banks.}

Even more importantly, the New Tigers made such significant gains of market shares while reaching much higher returns than the Old Mammoths. Indeed, between 1997 and 2003 the ROA (Return on Assets) of the SOBs halved from the poor 0.15% to 0.077%, while the New Tigers, though suffering a reduction, managed to keep their ROA at about 0.50%, a level which is comparable to what observed for the banking systems of developed countries (Figure 3). And a similar indication may be derived looking at the New Tigers’ ability to generate remuneration on their own capital: between 1997 and 2003, in spite of their low capitalization, SOBs’ ROE (Return on Equity) dropped from 4.3 to 1.6% while, though reduced over time as well, the ROE stood at about 8%, a level not far from those typical of developed countries.

**Figure 3. ROA and ROE: Old Mammoths vs. New Tigers**

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<tr>
<td>0.145</td>
<td>0.182</td>
<td>0.077</td>
<td>4.320</td>
<td>3.639</td>
<td>1.583</td>
</tr>
<tr>
<td>17,562</td>
<td>8,583</td>
<td>8,171</td>
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</table>

Source: Our computations on data derived from Bankscope.

II.4. Do the New Tigers offer China a growing out option?

In light of their growing market share coupled with better performance, it seems reasonable to ask whether the New Tigers are effectively supplanting the Old Mammoths. And, more broadly, do the New Tigers offer China a growing out option to overcome the
difficulties to restructure its impaired Old Mammoths\(^6\) and, through this, bring better banking to China?

There are two answers to this question. The first answer, somewhat mechanical and unsophisticated, may be derived through a simple forecasting exercise. In Figure 4 we report the forecasted market share of the New Tigers up to 2010 assuming that they keep growing at the rate experienced on average over 2000-2003 (27.2\%) while the SOBs continue expanding at the much lower average rate they had over the same period (10.0\%). This forecasting exercise is rather naïve in that it merely projects past trends to the future.\(^7\) It emerges that, under these hypotheses, the New Tigers could reach a market share above 45\% by 2010 (Figure 4). Should this come through, then one could deem that China’s banking problem would be greatly downsized (if not half solved) in just five years from now.

![Figure 4. Percentage market share of the New Tigers: Growing out forecast exercise](image)

Source: Our computations on data derived from Bankscope.

However, even though the scenario presented is not unrealistic from a macroeconomic perspective, there is no guarantee that it is also based on solid economic reasoning. To be sure, the continuation of the astonishing growth they experienced over the last few years postulates that the New Tigers really enjoy a competitive hedge all across the board vis-à-vis SOBs. But is this really the case? One way to address this issue is assessing whether the better performance of the New Tigers is fully attributable to their better corporate governance. It is exactly at this juncture that we notice a second trait distinguishing the New Tigers from

\(^6\) By the same token, it has been observed that, in the experience of transition economies, more progress is achieved through the entry of new banks rather than through rehabilitating old SOBs (Claessens, 1998).

\(^7\) The only caution we used was to check that the growth of total assets for China’s banking system was reasonable. We should stress that rates of growth increase going out to 2010, as the faster growing New Tigers enlarge their market share, but even so the rate of growth by 2010 is 17.2\% which does not appear patently unrealistic.
the Old Mammoths. The New Tigers concentrate their business in the most developed part of China, its vibrant Eastern Belt, while, on the contrary, the SOBs operate throughout the whole of China. As a result, it is not clear whether the New Tigers’ better performance owes entirely to their better corporate governance setup or whether geography gives these banks a great help too. For instance, according to Huang (2002), the SOBs generate 95% of their profits from about half dozen of the coastal cities, including Shenzhen, Guangzhou, Xiamen, Shanghai, Tianjin, and Beijing. If this is true, then shadows are cast on the possibility that the growth of the New Tigers can provide an effective solution to China’s banking problem out of China’s affluent Eastern Belt. As a consequence, to gauge how much of a solution to bring better banking to (the whole of) China the New Tigers may offer, we need to study in more depth whether geography matters behind their performance. This is the main task for the rest of our paper.

III. How important is geography behind the success of the New Tigers

III.1. The rationale behind looking at City Commercial Banks (CCBs)

We need to understand whether the New Tigers’ better performance is caused by better corporate governance only or whether and to what extent the New Tigers are better simply because they do business in the most developed area of China, thus escaping with their location the economic frailties the SOBs have to live with. To shed light on this issue, we design a field survey able to check whether, within (a significant segment of) the New Tigers, bank performance differs depending on the economic development of the geographical area where banks do their business. This is exactly the rationale behind looking at City Commercial Banks (CCBs), one of the most vibrant segment within the New Tigers, which happens to include banks located throughout the whole of China.

Figure 5. Percentage market share of the CCBs: Bankscope sample
Within our Bankscope sample, CCBs’s market share (in terms of total assets) almost doubled, from 1.9 to 3.5% between 1997 and 2003, while their weight within the New Tigers fluctuated around 15% (Figure 5). However, we should remark that Bankscope under-samples CCBs, including only 16 out of 112 of them: Considering all of the 112 CCBs, their market share is about 5%.

CCBs came about after 1995 when the People’s Bank of China put in order NPL-endangered urban credit cooperatives. Urban credit cooperatives were salvaged with the injection of public funds but, at the same time, they were ordered to merge consolidating into the newly formed CCBs, established as joint-stock companies. CCBs inherited from urban credit cooperatives all NPLs formed during the “nonstandard operating period” (1985-1995; Girardin and Ping, 1997): at the end 2003, 39 out of 112 CCBs had an NPL ratio above 20%, some of them even above 70%. CCBs’ shareholders include urban enterprises, citizens and local governments (individuals are not allowed to become new shareholders). At present, city commercial banks are distributed in 112 central cities (district-level or above) of China – one city one city commercial bank without exception. Though they almost cover the whole of China, their distribution uneven. Generally speaking, there are more CCBs in Eastern provinces (e.g., there are 11 CCBs in Jiangsu Province) than in Western provinces (in Gansu, Qinghai, Xinjiang and Ningxia, CCBs exist only in the capital cities). Since their foundations, the financial authority has been requiring all city commercial banks to offer financial services only within the cities’ own administrative districts.

By end June 2004, the 112 city commercial banks were endowed with: 5,154 branches; 107,000 employees; a 5-grade NPL ratio of 14.1%. Among the various categories of financial institutions, city commercial banks rank second in terms of business development, just next to joint-stock commercial banks. CCBs focus on three main business lines: (1) providing indirect financial services to SMEs; (2) offering financial services for city residents; (3) financing local governments in fundamental (or public) facilities’ construction.
III.2. Structure of the field survey on 20 CCBs from three provinces

By focusing on 20 CCBs located in three provinces of China featuring diverse levels of economic development, we keep corporate governance (relatively) constant and can, thus, ascribe any significant difference in performance across the provinces to their relative kunderlying prosperity.

Table 1. Basic Information on the three provinces (2003)

<table>
<thead>
<tr>
<th>Province</th>
<th>Population (million)</th>
<th>Economic Growth Rate</th>
<th>Area (10 thousand km)</th>
<th>GDP Per Capita (Yuan/person)</th>
<th>CCBs surveyed in the province</th>
</tr>
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<tbody>
<tr>
<td>Chekiang</td>
<td>46.13</td>
<td>14.0</td>
<td>10.2</td>
<td>19,944</td>
<td>7 CCBs: Jinhua, Huzhou, Hangzhou, Jiaxing, Wenzhou, Shaoxing, Taizhou</td>
</tr>
<tr>
<td>Hubei</td>
<td>59.75</td>
<td>9.3</td>
<td>18.6</td>
<td>9,031</td>
<td>5 CCBs: Yichang, Jingzhou, Wuhan, Xiaogan, Huangshi</td>
</tr>
<tr>
<td>Sichuan</td>
<td>86.40</td>
<td>11.8</td>
<td>48.5</td>
<td>6,315</td>
<td>8 CCBs: Leshan, Luzhou, Panzhihua, Deyang, Zigong, Nanchong, Chengdu, Mianyang</td>
</tr>
<tr>
<td>Total</td>
<td>192.28</td>
<td></td>
<td>77.3</td>
<td></td>
<td>20 CCBs</td>
</tr>
<tr>
<td>China</td>
<td>1,276.27</td>
<td>9.1</td>
<td>960</td>
<td>9,143</td>
<td>112 CCBs</td>
</tr>
</tbody>
</table>

We selected the three provinces to include: One with a level of prosperity just about China’s average, this is Hubei province; One ranking among the most developed, this is Chekiang province (with a GDP per capita about double China’s average); One less affluent, this is Sichuan province (with a GDP per capita about 2/3 of China’s average; Table 1).

As shown in the table, not only GDP per capita but also growth is fastest in Chekiang, while Sichuan, though less developed, is enjoying faster growth than Hubei. Thus, while Chekiang stands out in both the level and the dynamics of GDP, Hubei is ranked before Sichuan if we look at GDP per capita but the order is reversed if we take growth into account. The 20 interviewed CCBs are distributed as follows: 7 in affluent Chekiang, 5 in mid-income Hubei, 8 in less developed Sichuan. For all of these CCBs the survey collected information on their asset-liability/profit-loss accounts over 2000-2003 as well as on their business features and several ownership and corporate governance aspects.

III.3. Different patterns of performance in more vs. less developed provinces

Over the 4 years 2000-03, total assets of the CCBs expanded by 1.58 times in Hubei, by 2.15 times in Sichuan, and by 2.75 times in Chekiang. Such ranking of the expansion of the banking business across the three provinces seems consistent with GDP growth.

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8 The survey was conducted by the Research Institute of Finance at the Development Research Center of the State Council operating on behalf of the Asian Development Bank Institute, Tokyo.
Interestingly, both size and performance improve on average when we move from the less affluent Sichuan and Hubei to the most prosperous Chekiang. The average size of Chekiang CCBs is three times as large as that in the other two provinces (Figure 6). Assets per employee, one of the basic indicators of productive efficiency, is twice as large in Chekiang with respect to Hubei and Sichuan. The average ROA is close to 1.5% in Chekiang, five times as large as in the other two provinces. In addition, the NPL ratio is just below 5% in Chekiang, 1/5 of Hubei and 1/4 of Sichuan.

Chekiang CCBs stand out also in terms of ROE as well as in terms of their ability to generate profits out of their net interest income. ROE is three times as large for them as in Sichuan, while Hubei CCBs are barely able to generate positive returns (Figure 7). Profits/net interest income is close to 60% in Chekiang, twice as large that in Hubei and three times that of Sichuan.

Figure 7. ROE, profits and loan loss provisions of CCBs by province
Chekiang CCBs achieve higher profit efficiency in spite of larger loan loss provisioning, where loan loss provisions are visibly low in Sichuan and intermediate in Hubei. All in all, loan-loss reserves are probably insufficient: in 2003 the loan-loss reserves of the 20 investigated CCBs were merely 1.25% of total loans, well below their average 14% NPL ratio. In addition, CCBs have high loan concentration ratios: (i) some CCBs overly pursue prime customers; (ii) insiders and big shareholders cause problems of loans to their related enterprises; (iii) risk management systems lag behind.

III.4. Further significant evidence from the field survey

CCBs are basically controlled by local government and their internal governance structures still need large improvement: on average, direct share-holding by the local government is 24.2% but adding indirect shareholding brings to some 2/3 of total equity controlled by state-owned capital; domestic private shareholders stand at 23.7%. The situation differs across the three provinces. While direct shareholding by local governments is not so different, the picture changes drastically one we add to it shareholding by SOEs: On average, the sum reaches above 60% in Hubei, above 40% in Sichuan, while stopping below 30% in Chekiang (Figure 8).

Figure 8. Local governments and SOEs shareholding in CCBs by province
We also learn from the survey that the local government has the final influence in selecting the chairman and president of CCBs, who are in charge of key decisions. It appears that related party loans to finance local government initiatives (e.g. infrastructure) may be a problem (also this could hide quasi-fiscal liabilities). We also notice that, within each province, there is a positive correlation between the weight of individual & family shareholding and the NPL ratio. This is suggestive of a potential monitoring problem when shareholding is dispersed.

It is worth stressing a final point on the potentially dangerous link between large shareholding by the local government and SOEs whereby CCBs might be captured by political influence. The survey offers some evidence to this. The first step shows that, on individual bank data, there is a strong positive correlation between the weight of the local government together with SOEs as shareholders and the share of CCB loans going to the local government plus SOEs (Figure 9). This is consistent with the hypothesis that CCBs may be captured the local government plus SOEs: When these are large shareholders, it may be very difficult for CCBs to deny credit to them. The second step consists in looking at whether there is also a positive correlation, on individual bank data, between the share of loans to the local government plus SOEs and NPL ratios. As reported in Figure 10, we do find some positive link also in this respect, but the correlation is much weaker than in the first step.

This evidence is consistent with the results of the mentioned PBOC’s survey on the causes of NPLs at SOBs (Zhou, 2004a).

Figure 9. Local governments and SOEs shareholding and CCB loans to them
This hypothesis that captive CCBs are potentially endangered by political interference may explain why, in spite of performance is relatively poor in Hubei province with respect to what one might expect from its level of development indicated by a GDP per capita on par with the whole of China. As reported in Figure 11, Hubei CCBs stand out at the top in terms

Figure 10. Loans to local governments and SOEs and NPL ratios
of both shareholding by local government plus SOEs and share of loans allocated to them. Unsurprisingly, Hubei CCBs are at the top also in terms of the NPL ratio.

Figure 11. The influence of local governments and SOEs on NPL ratios by province

Thus, it seems that, keeping corporate governance (relatively) constant, geography is a strong determinant of performance. Accordingly, the view that the New Tigers are the solution to bring better banking to China seems too simplistic. To be sure, we have remarked that corporate governance differs even within CCBs, where those CCBs more exposed to political influence are worse performers. However, this observation would only take our point one step further. Specifically, it is possible that higher development induces better governance by decreasing the appetite of local governments and SOEs. However, once more, this implies that corporate governance is to some extent endogenous and, in any event, what works in China’s affluent Eastern Belt may not work in less developed areas. This casts shadows on the possibility that the New Tigers may offer China an effective solution to deal with its banking problem and, as a result, forces policy makers to turn again to improve the situation of the NPL-endangered SOBs.

IV. Conclusions

We tried to delve into the manifest problems of China’s banking system, currently posing a threat to the continuation of the Chinese economic miracle. We argued that the persistence of a latent banking crisis in a country experiencing average annual growth around 9% for some 25 years is only an apparent puzzle. We claimed that the crux of the banking problem stems from the unhealthy strict link between loss-making SOEs and SOBs, which we
labeled the “Old Mammoths” and still dominate banking in China. We posited that this noxious SOE-SOB brotherhood did not materialize by chance but, rather, was the dark side of the policy choice for gradual transition, which let unprofitable SOEs in business while, due to political interference, SOBs could not discontinue lending them and, later, bearing the losses.

Next we discussed how to bring better banking to China. First, we reached the conclusion that foreign banks will only play an ancillary, though very important, role in this. Given China’s size, it is unlikely that foreign banks can manage retail banking throughout the country. Then, we asked whether the emergence of a new breed of vibrant Chinese banks (the “New Tigers”) can be the answer. Indeed, we provided details on the intense growth of the New Tigers, articulating also a performance comparison between them and the Old Mammoths (the SOBs). At this point, we addressed whether the New Tigers offer China an option to growing out of its banking problem. Although extrapolating the New Tigers’ growth might lead one to answer that they are rapidly supplanting the Old Mammoths, we posited that a thoughtful answer to this question requires carefully evaluating the sources of the New Tigers’ better performance. Specifically, we needed to understand whether this is caused by better corporate governance only or whether and to what extent the New Tigers are better simply because they do business in the most developed area of China, thus escaping with their location the economic frailties the SOBs have to live with.

To accomplish this task, we designed a field survey able to check whether, within (a significant segment of) the New Tigers, bank performance differs depending on the economic development of the geographical area where banks do their business. This was exactly the rationale behind looking at City Commercial Banks (CCBs), one of the most vibrant segment within the New Tigers, which happens to include banks located throughout the whole of China. By focusing on 20 CCBs located in three provinces of China featuring diverse levels of economic development, we kept corporate governance (relatively) constant and could, thus, ascribe any significant difference in performance across the provinces to their relative underlying prosperity. We reached some results confirming that CCBs’ performance is systematically and positively related to the level of economic prosperity in their province. This shed new light on our main point. We also gained additional insight on other factors affecting bank performance in China.

The main result of our analysis suggests that the New Tigers may be unable by themselves to bring better banking to (the whole of) China. Thus, it seems that Chinese authorities are right in stressing the need to restructure and rehabilitate the Old Mammoths. While the authorities’ push to corporatize the SOBs goes in the right direction, it is not clear that their listing on the stock exchange can really, per se, improve the SOBs’ corporate governance. Given their size and considering that the government could continue to be the largest shareholder, it is legitimate to doubt that simple listing will change SOBs’ conduct. Perhaps, as suggested by Huang (2002), it would be advisable for China’s authorities to consider breaking up its Old Mammoths. Such a measure would help streamline the SOBs and could also facilitate the processes of introducing foreign strategic investors and public listing.
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