Banking System of China

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Main Contents

- Introduction of banking system
- Banking institutions
- Banking regulators
- Banking reforms
- Regulatory Implementation

I Introduction of Banking System

Key features of China's banking system

- Biggest supplier of credit as opposed to capital markets
- Highly concentrated in big banks
- High level of state ownership and control:
  - The largest five banks are majority-owned by the central government
  - Government can give credit guidance
  - Top management are selected by the government and are effectively high-level government officials in practice.
  - Largely focus on traditional financial intermediation between savers and borrowers:
    - Domestic deposits are the largest funding source (80% of total liability)
    - loans are the largest chanel for financing the borrowers(60% of total asset)

Chinese banking industry has made rapid progress and maintained leading role

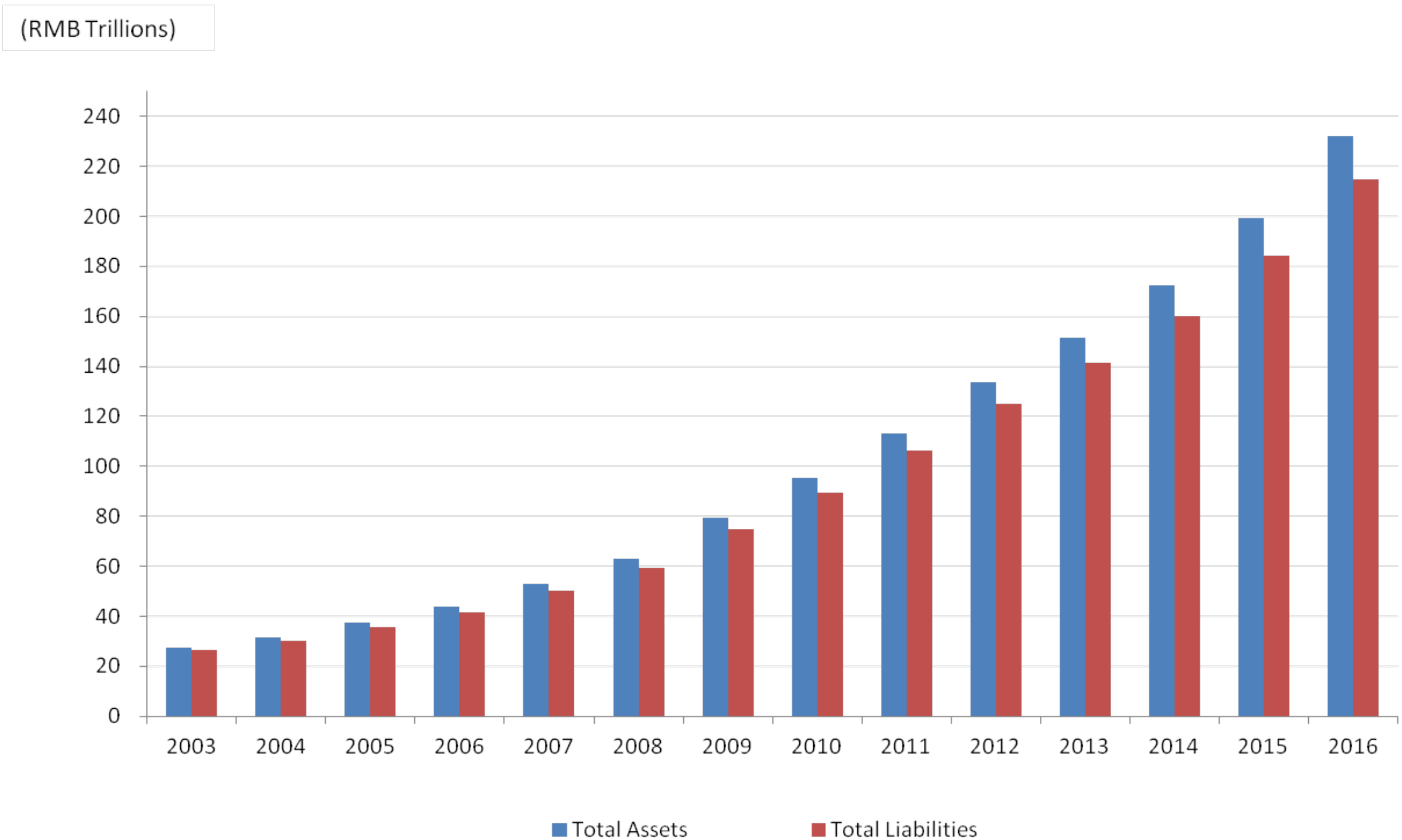
- In The Banker's list of the 1000 top banks in the world, **126** were Chinese
- Among the top ten banks ranked by tier one capital, Chinese banks and U.S. banks took **four** places each

Top 10 banks in 2017 ranked by *The Banker* (in US$ million)

Rank	Bank	Country	Tier one capital	Pretax Profit	Total Asset
1	ICBC	China	281,261.87	52,270.36	3,472,987.77
2	CCB	China	225,838.13	42,476.26	3,016,360.43
3	JP Morgan	U.S.	208,112.00	34,552.00	2,490,972.00
4	BOC	China	199,189.06	32,001.73	2,611,350.94
5	BOA	U.S.	190,315.00	25,153.00	2,189,266.00
6	ABC	China	188,623.60	32,607.77	2,815,836.12
7	Citigroup	U.S.	178,387.00	21,398.00	1,792,077.00
8	Wells Fargo	U.S.	171,364.00	32,120.00	1,930,115.00
9	HSBC	U.K.	138,022.00	7,112.00	2,374,986.00
10	MUFG	Japan	135,943.69	11,630.77	2,706,804.40

Data source: *The Banker* 2017 July

Total Size of China’s Banking System



Banking institutions dominate China’s financial system

Structural changes in the total assets of China’s financial system in the 2003-2016 period (in RMB bn)

Year	Banking institution total assets	Non-bank financial institutions total assets	Percentage of total assets owned by banking institutions
2003	27,658	910	97%
2004	31,599	873	97%
2005	37,470	1,016	97%
2006	43,950	1,059	98%
2007	53,116	972	98%
2008	63,152	1,180	98%
2009	79,515	1,550	98%
2010	95,305	2,090	98%
2011	113,287	2,607	98%
2012	133,622	3,230	98%
2013	151,355	3,968	97%
2014	172,336	5,012	97%
2015	199,345	6,488	97%
2016	232,253	7,931	97%

Banking institutions dominate China's financial system

Structure of China's AFRE in the 2003-2017 period (in RMB bn)

Year	Social financing	RMB/foreign currency loans and bank's acceptance bill	Entrust loans	Trust loans	Corporate bonds	Non-financial enterprises' domestic stock financing	Other
2003	3,411	90%	2%	0%	2%	2%	2%
2004	2,863	87%	11%	0%	2%	2%	2%
2005	3,001	84%	7%	0%	7%	1%	3%
2006	4,270	81%	6%	2%	5%	4%	2%
2007	5,966	75%	6%	3%	4%	7%	2%
2008	6,980	78%	6%	5%	8%	5%	2%
2009	13,910	78%	5%	3%	9%	2%	2%
2010	14,019	64%	6%	3%	8%	4%	2%
2011	12,829	66%	10%	2%	11%	3%	0%
2012	15,763	60%	8%	8%	14%	2%	0%
2013	17,317	56%	15%	11%	10%	1%	0%
2014	16,457	64%	15%	3%	15%	3%	0%
2015	15,409	74%	10%	0%	19%	5%	0%
2016	17,802	74%	12%	5%	17%	7%	0%
2017	19,443	76%	4%	12%	2%	5%	0%

Structure of China’s banking system

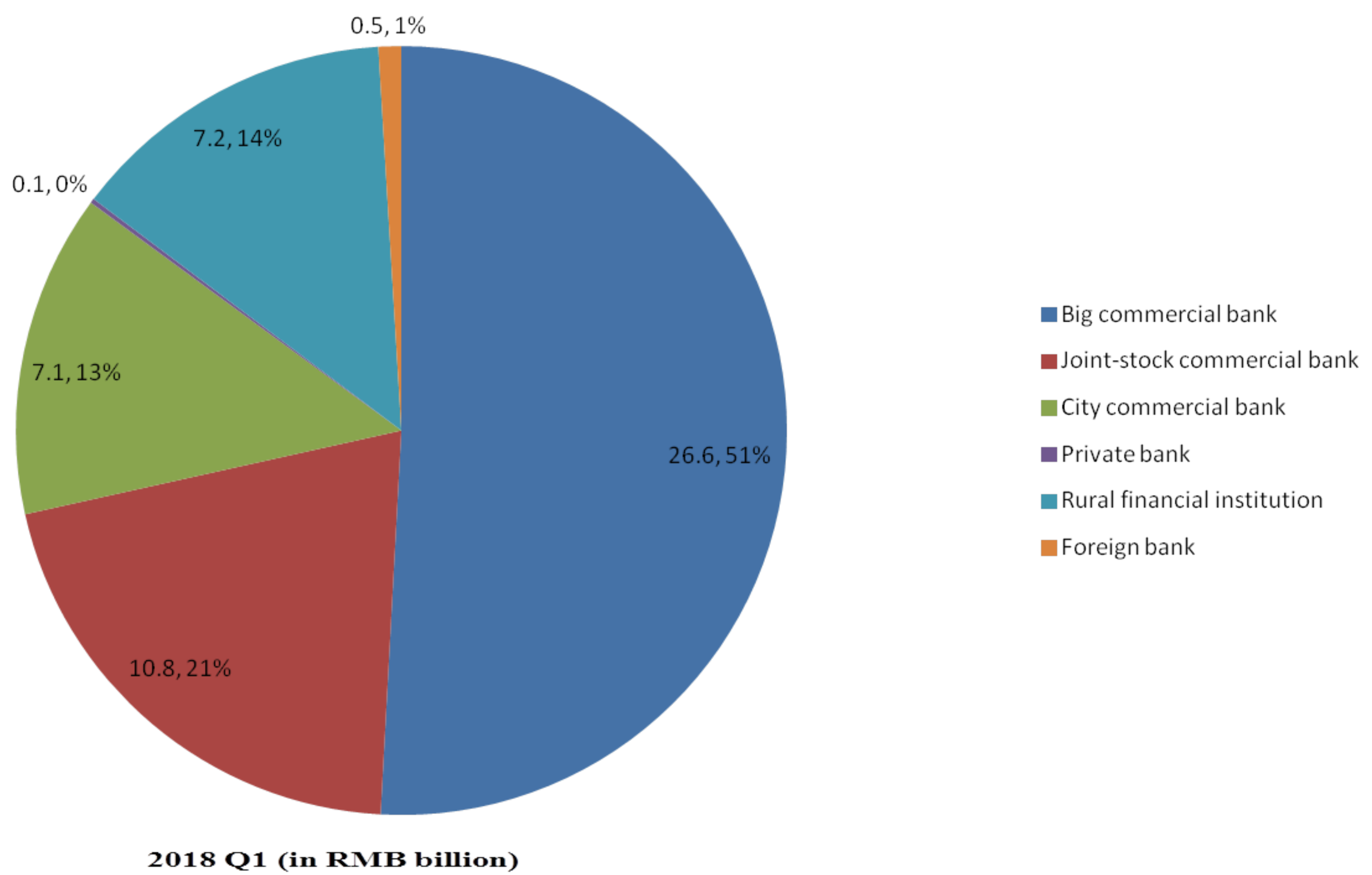
- **Banking institutions:**
  - Policy banks
  - State-owned commercial banks (big 5)
  - Joint-stock commercial banks
  - Private banks
  - City commercial banks
  - Rural area financial institutions
  - Foreign banks

- **Banking regulators:**
  - PBC
  - MOF
  - CBRC
  - SAFE

- **Capital Structure of the banks:**
  - Fully state -owned
  - Partially state-owned
  - Private
  - Foreign

High concentration in big banks

Composition of profits of China's banking industry in 2018 Q1 (in RMB billion)



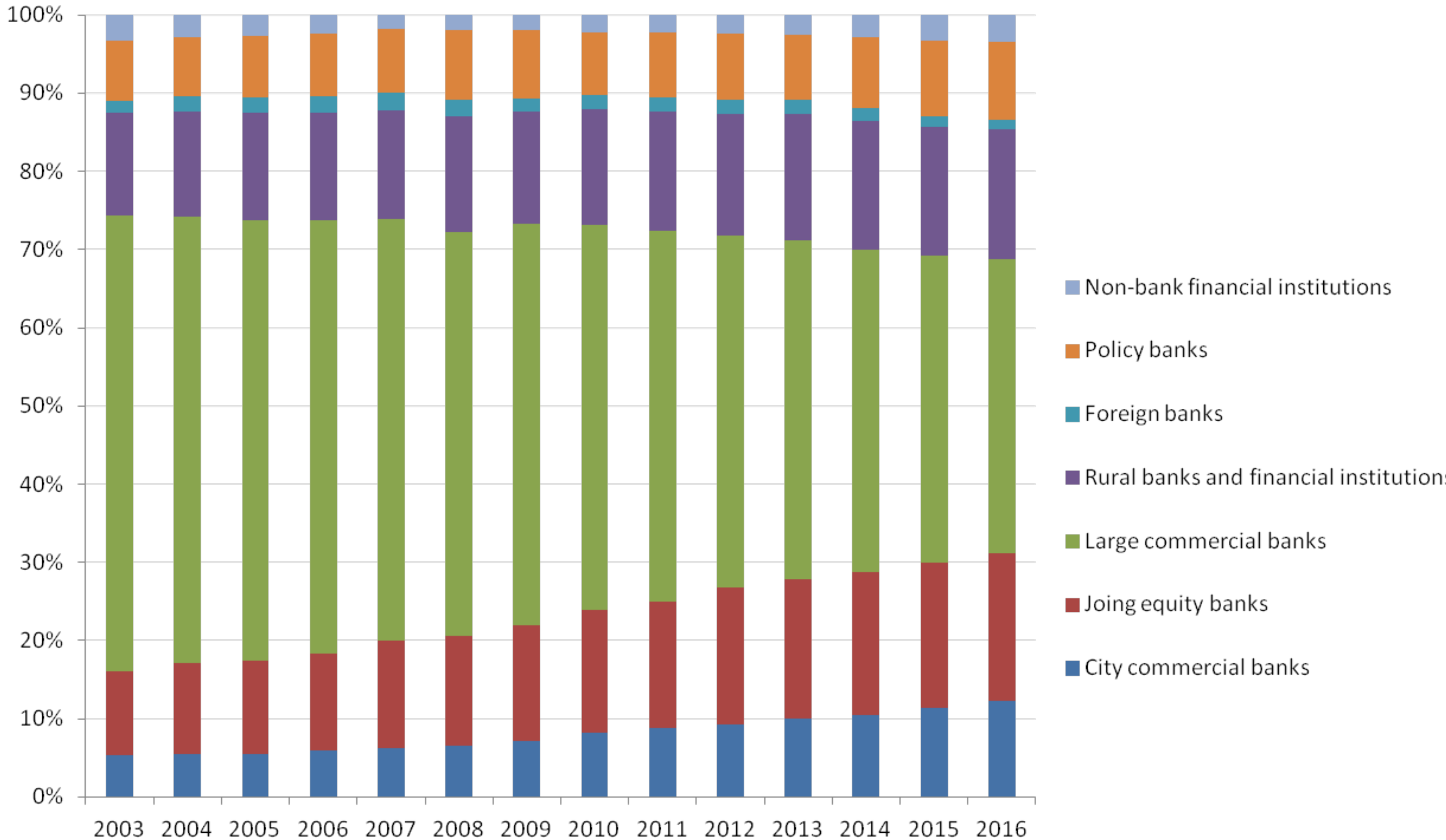
Data source: WIND

High concentration in big banks

Structure of total assets of China's banking institutions during the 2004-2017 period (in RMB bn)

Year	Assets of banking institution	Assets of big commercial banks	Percentage of assets owned by big commercial banks
2004	31, 599	16, 937	53.60%
2005	37, 470	19, 672	52.50%
2006	43, 950	22, 546	51.30%
2007	52, 598	27, 982	53.20%
2008	62, 391	31, 820	51.00%
2009	78, 769	40, 094	50.90%
2010	94, 259	45, 904	48.70%
2011	111, 518	51, 968	46.60%
2012	131, 266	57, 888	44.10%
2013	148, 047	62, 624	42.30%
2014	168, 161	67, 264	40.00%
2015	194, 175	73, 592	37.90%
2016	226, 256	81, 452	36.00%
2017	245, 778	87, 251	35.50%

Banking and Financial Institutions: Breakdown of Market Share by Type, 2003-2016



The dominance of the big five has shrunk in recent years. The share of total assets fell from 58% to 38% from 2003 to 2016.

II Banking Institutions

Policy banks

- Wholly State-Owned & each with a distinct mission. Established in an effort to separate policy-related lending from commercial lending.
- **Agricultural Development Bank of China (ADBC)**
  - To support the development of agriculture and rural areas in China
  - All of ADBC's loans went to providing credit for agricultural production
- **China Export-Import Bank (CEIB)**
  - Provide financial services to promote Chinese exports (particularly of high-tech and new-tech products) and facilitate the import of technologically advanced machinery and equipment
  - The main areas supported by the CEIB are the external economy, trade development and cross-boundaries investment, "The Belt and the Road" construction, international cooperation on production capacity, a "going global" policy for small-sized and medium-sized business, etc.
- **China Development Bank (CDB)**
  - CDB is the biggest development finance institution in the world and China's largest foreign investment and finance cooperative bank, medium- to long-term credit bank, and bond bank
  - It mainly provides strategic services for important medium- to long-term national economic initiatives through financial services such as medium- to long-term credit and investment.
- Funding and governance
  - Funded by capital contribution from the central government and issuing policy bonds (backed by government)
  - All three banks have a board of directors and senior officers, appointed by the central government.
  - Rely on the central government's directives in establishing their operational priorities.

State-owned commercial banks

- Bank of China, Agricultural Bank of China, China Construction Bank, and Industrial and Commercial Bank of China, Bank of Communications
  - The largest five banks are majority-owned by the central government and focus on traditional financial intermediation between savers and borrowers
  - All are highly profitable in recent years with low loan default ratios
  - The big banks strive to balance the goal of earning profits and expanding operations with the overall economic policy objectives of the State Council, PBC, and other government agencies

Table: Simplified Balance Sheet for five big banks

In December 2016,CNY billions

	ABC	BOC	Bank of communication	CCB	ICBC
Total Asset	19570.06	18,148.89	8,403.17	20963.71	24,137.26
loans	9319.36	9735.65	4,009.05	11488.35	12,767.33
corp loans	5803.2	6331.26	2790.18	6823.94	8140.68
personal loans	3346.4	3404.39	1186.19	4420.94	4796.17
investment	5688.25	4227.61	2420.41	5268.86	6361.34
cash & balance with other banks	622.66	582.43	179.95	494.62	270.06
Liabilities	18248.47	16,661.80	7,770.76	19374.05	22,156.10
deposit from customers	15,038	12,939.75	4,728.59	15402.92	17,825.30
corporate deposits	5,599.7	6721.33	3,206.24	8008.46	9,448.52
personal deposits	8,815.1	5482.36	1,517.56	6927.18	8,140.28
deposit from other financial institute	1156.04	1420.53	1,253.99	1612.99	1,516.69
New worth	1358.44	1,487.09	632.41	1,589.65	1,981.16

- Mainly funded by deposits
- Loans constitute a large portion of total assets than securities

Joint-Stock Commercial Banks

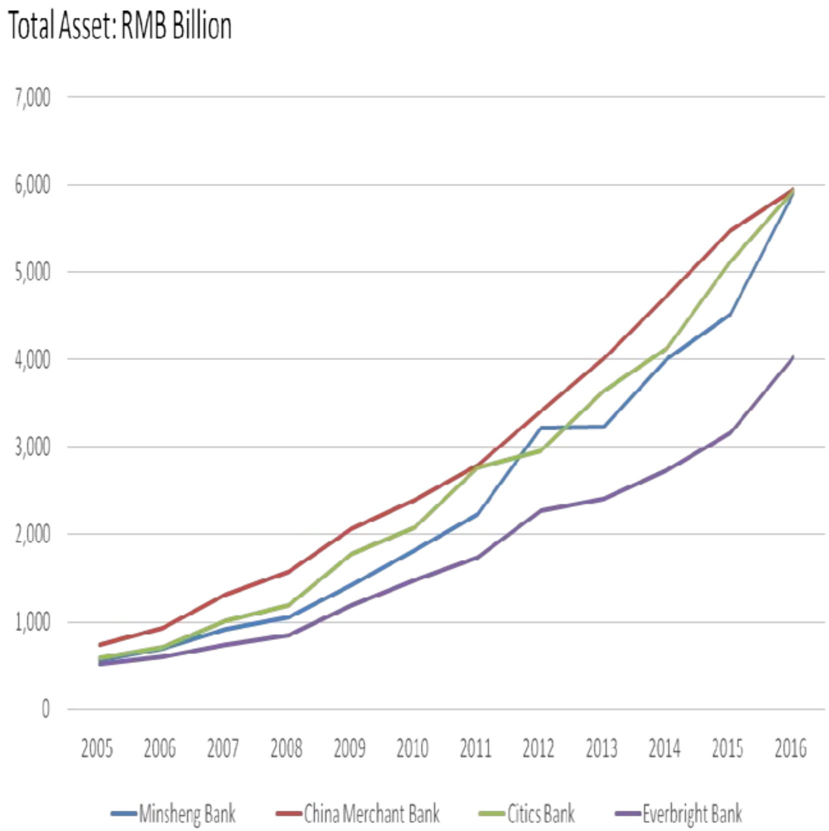
- The most common form for private capital to infiltrate the banking sector is through joint-stock banks. Solely privately owned banks are rare

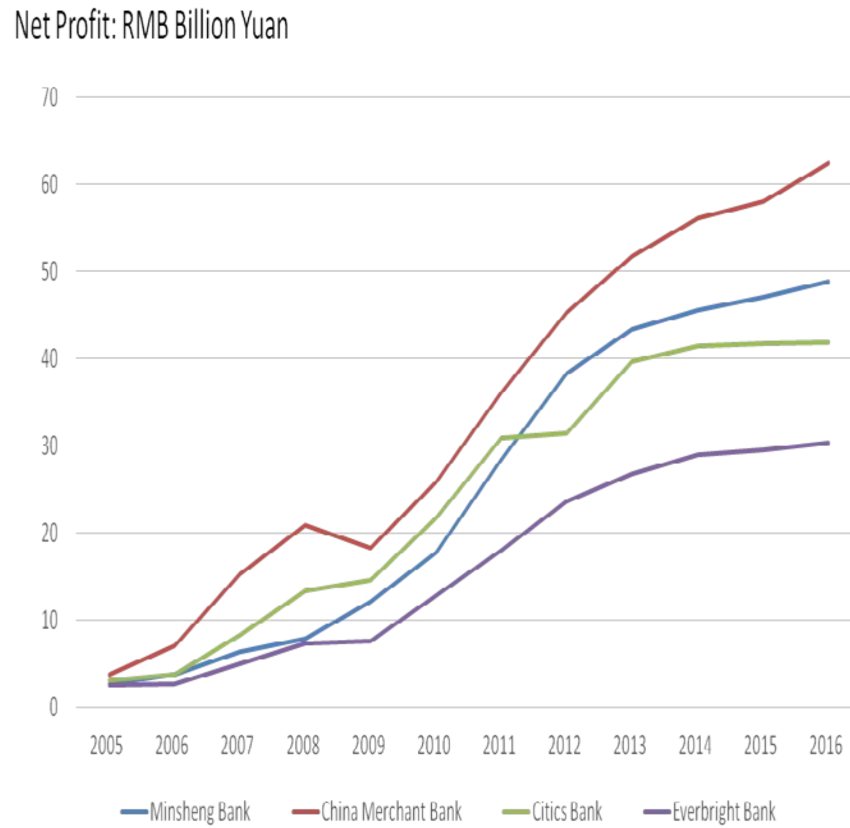
- Joint-stock banks are held by corporations, which could include non-State entities, instead of by the State directly
  - They are not completely privately owned, but the governments' stakes in them are significantly less than the big five

- China Minsheng Bank is the first commercial bank in mainland China that was founded on private capital

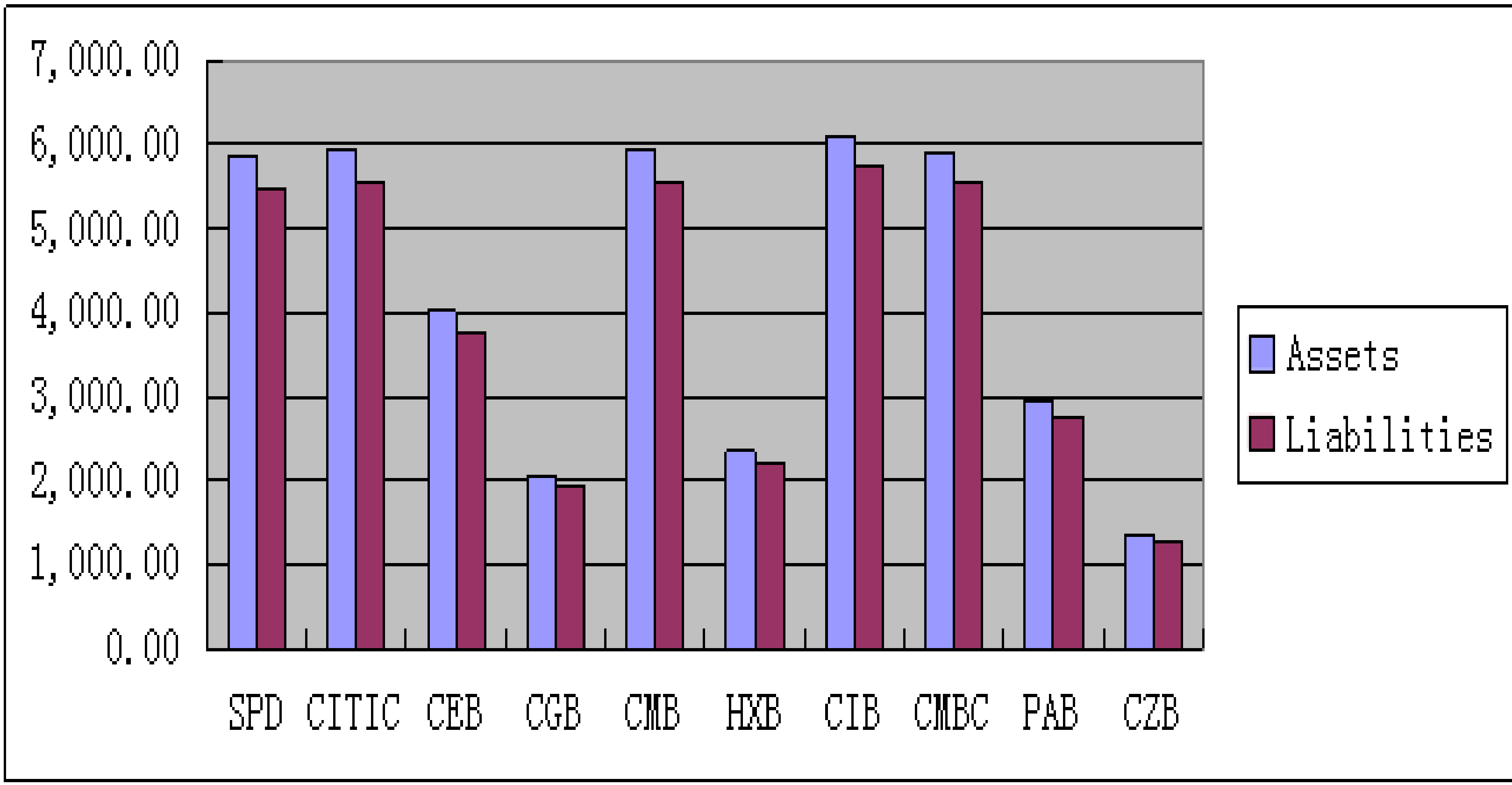
- The banks included are the Shanghai Pudong Development Bank (SPD), China Citic Bank (CITIC), China Everbright Bank (CEB), China Guangfa Bank (CGB), Guangdong Development Bank (CMB), Huaxia Bank (HXB), China Merchants Bank (CMB), China Minsheng Bank (CMBC), Ping An Bank (PAB) and China Zheshang Bank (CZB)

Joint-Stock Commercial Banks





Assets and liabilities of ten joint-stock commercial banks



December 2016 (in RMB billion)

Shareholder status of China's state-owned commercial banks and China's joint-stock commercial banks

December 2017	The largest shareholder	The largest shareholder proportion (%)	Top 10 shareholders proportion (%)
ICBC	Central Huijin Investment Co., Ltd.	34.71	96.61
ABC	Central Huijin Investment Co., Ltd.	40.03	94.83
BOC	Central Huijin Investment Co., Ltd.	64.02	96.08
CCB	Central Huijin Investment Co., Ltd.	57.11	97.44
BCM	The Ministry of Finance	26.53	78.76
CMBC	Anbang Life Insurance co.,Ltd.	6.49	57.26
CITIC	China CITIC Co., Ltd.	65.37	97.83
CEB	China Everbright Group	25.43	92.25
CMB	China Merchants Steamship Co.,Ltd.	18.02	69.25
SPD	Shanghai International Group Co.,Ltd.	21.57	76.06
HXB	Shougang Group Co., Ltd.	20.28	74.7
PAB	Ping An Group	49.56	66.36

Private Banks

- Recent development: CBRC started a pilot program in 2014 to allow private capital to found banks
  - Targeted clientele: Micro-Small enterprises, rural area development, and communities.
  - The main objectives are to try out a new scheme in which banks are responsible for their own risks.
  - Different Business models:
    - Small deposits, small loans: e.g. Ali Loan by Alibaba
    - Large deposits, small loans: e.g. WeBank by Tencent
    - Only serves corporations
    - Designated geographic area

Other domestic banks

- **City commercial banks:**
  - Were wholly-owned by local government but transformed into joint-stock banks since 2000s where the local government being the biggest shareholder
  - Often chosen to handle local government related accounts
  - Better able to assess local companies' credit worthiness
  - The establishment of branches of city commercial banks in other cities is restricted to a certain extent, and the number of branches is much less than that of joint-stock commercial banks

- **Rural area financial institutions:**
  - including rural credit cooperatives， village and township banks (TVB), rural commercial banks, rural cooperative banks
  - Generally only provide services to rural population
  - Private capital accounts for 90% of the total capital in rural co-operatives and 70% of the capital in rural banks.

Foreign Banks in China

- Foreign banks are focusing on foreign companies as their main costomers, so the market share in China's banking system keeps at very low level.

Assets of foreign banks operating in China in the 2003-2016 period (in RMB billions)

Year	Banks with foreign capital: Assets	Banking institutions: Assets	Percentage of banks with foreign capital
2007	1,253	53,116	2.36%
2008	1,345	63,152	2.13%
2009	1,349	79,515	1.70%
2010	1,742	95,305	1.83%
2011	2,154	113,287	1.90%
2012	2,380	133,622	1.78%
2013	2,563	151,355	1.69%
2014	2,792	172,336	1.62%
2015	2,681	199,345	1.34%
2016	2,929	232,253	1.26%

III Banking Regulators

China’s Banking Regulators

- **Four key entities report to China’s ruling State Council**
  - China’s central bank is the People’s Bank of China (PBOC)
  - China Banking Regulatory Commission (CBRC)
  - Ministry of Finance (MOF)
  - State Administration of Foreign Exchange (SAFE)

People’s Bank of China

- **History:**
  - Before 1978, the PBOC functioned as both the central bank of China and as the only commercial bank. Administratively under the MOF
  - 1980s, four state-owned banks were established through parts of PBOC to be commercial banks. The PBOC had a more focused goal of being the central bank

- **Responsibility (more on this later):**
  - Setting monetary policy (such as setting benchmark interest rates)
  - Ensuring financial stability
  - Managing the payment system
  - Regulating inter-bank lending and bond markets, gold market, foreign exchange markets

China Banking Regulatory Commission

- Created in charge of the regulatory oversight of China's banks in 2003

- **Main Functions:**
  - Authorize the establishment and business scope of banks in China
  - Formulate and enforce banking regulations
  - Audit and supervise all banks
  - Compile and publish information on China's banking sector

- In January 2015, the CBRC carried out the reform of the regulatory framework, set up the Prudential Regulation Bureau, led the non-field supervision work, and unified the rules and regulations of the Prudential Management of the banking industry

- On April 8, 2018, the CBRC became a part of the China Banking and Insurance Regulatory Commission (CBIRC)

Ministry of Finance

- MOF is the national executive agency of China’s central government and was once the sole authority for China’s financial sector

- **Main functions:**
  - Administers macroeconomic policies
  - Prepares and administers the national budget
  - Handles fiscal policy, economic regulations, and government expenditures for the state

- Although the direct management of financial institutions by the MOF has been reduced, it continues to hold some authority either through equity holdings or by having a representative on the banks’ governing boards

State Administration of Foreign Exchange

- Administratively under the State Council and the PBOC, The foreign exchange management structure has been gradually improved over the past years

- **Main Functions:**
  - Manage China's foreign exchange reserves
  - Regulating and monitoring foreign exchange transactions, as well as balance of payments statistics
  - Sometimes acts as a bank providing credit to companies seeking to make overseas investments
  - Regulates QFIIs – authorizes quotas

- **At the operational level of a commercial bank, the SAFE is responsible for:**
  - The supervision of the national foreign exchange market
  - The settlement and sale of foreign exchange
  - Cultivating and developing the foreign exchange market and punishing acts that are against foreign exchange regulations

IV Banking Reforms

Background of the banking reforms

- In late 1990s, due to the Asian financial crisis and management problems within the Chinese banks, substantial non-performing loans accumulated in the banking system, preventing them from making new loans to the economy.
- In November 1998, The Ministry of Finance issued a special treasury bond of 270 billion Yuan, which is specially used to supplement the capital of the four major state-owned banks (ICBC, ABC, BOC and CCB)
  - The PBOC has reduced the required reserve requirement ratio from 13% to 8%
  - The bank funds released were used to purchase special treasury bonds
  - The Ministry of Finance injected capital into the four banks with income of special treasury bonds
  - The state-owned commercial banks use the funds to repay the refinancing of central banks

Background of the banking reforms

- In 1998, 270 billion special treasury bonds were injected into state-owned banks
  - Bankruptcy of Hainan Development Bank & Guangdong International Trust & Investment Corporation (GITIC)
- From 1998 to 1999, the four major banks replenished capital and cleaned up balance sheet through capital injection, non-performing assets stripping and other financial restructuring methods
  - The four asset management companies (Great Wall, Huarong, Xinda, Oriental) separated 1,394 billion RMB in non-performing loans from the Big Four Banks and the China Development Bank (CDB), lowering the non-performing loan ratio of the Big Four Banks by an average of 10%
- Since 2001, China has gradually implemented a five-category assets classification method for bank loans, and gradually lowered the business tax of commercial banks.
  - The first round of reforms was mainly technical, for example, handling the non-performing assets, enhancing internal management, etc., without addressing the in-depth systematic and mechanical issues

Reform of Big Banks in 2003-2010

- At the end of 2003, the central government chose the **Bank of China (BOC)** and **China Construction Bank (CCB)** as the pilot banks for the new shareholding system. Through the newly established Central HuiJin Investment Co., **USD $45 billion of China's foreign exchange reserve** was injected into the state-owned commercial banks to begin a new round of reform along with the public listing process

- **The second round of reform of the Big Four Banks occurred in four stages:**

Financial restructuring and capital injection → Establishing joint stock companies → Introducing strategic investors → Pushing for IPO

Reform of Big Banks in 2003-2010

The path of Shareholding System Reform

Financial restructuring and capital injection

Establishment of joint-stock companies

Introducing strategic investors

IPO

Milestones of reform

2010	ABC was listed at both A + H shares
2009	ABC Limited Share Ltd was founded
2008	ABC joint-stock reform began
2007	CCB listed on A shares; BCM listed on A shares
2006	BOC listed on H shares and A shares; ICBC simultaneously listed on A + H shares
2005	CCB listed in HK; ICBC’s shareholding system reform approved; BCM listed on H shares
2004	Restructuring of the BOC and CCB in accordance with the shareholding system reform
2003	Chinese government approved the shareholding system reform of the BOC and CCB

The results of the Reform of Big Banks

- **These reforms fundamentally strengthened the financial condition of the banking sector and the internal control mechanism and risk management capability were also improved**
  - Total assets and loans balance increased significantly and the NPL ratio dropped rapidly to around 2%
  - Capital adequacy rate increased and changed from a negative to a positive percentage
  - Stress tests showed that the major banks' capital buffer was strong enough to withstand significant shocks (IMF, 2011)

(100 millions, %)

	ICBC		Agriculture Bank of China		Bank of China		China Construction Bank		Bank of Communications	
	2003	2015	2003	2015	2003	2015	2003	2015	2003	2015
Total assets	52791	222098	34940	177914	39800	168156	35531	183495	9217	71554
Loan balance	33929	116073	22684	89099	19211	91359	19960	104851	5499	37220
NPL ratio	21.24	1.50	30.66	2.39	16.28	1.43	12.4	1.58	11.86	1.51
Net Profit	25	2777	19	1808	287	1794	224	2289	44	665
Capital Adequacy ratio	−8.81	15.22	−23.6	13.40	5.39	14.06	6.51	15.39	7.41	13.49

The results of the Reform of Big Banks

- **The market position and international competitiveness have been improved significantly**
  - The number of Chinese banks on the list of the top 1000 big banks worldwide increased from 15 (2002) to 83 (2010)
  - Both the profit levels and market capitalization of the four state-owned banks reached the top levels
  - The capital adequacy ratio, provision coverage ratio, and return on assets ratio all reached historically high levels and surpassed other global banks

BANKS	Market value	Asset Scale	Tier I capital	Pre tax profit
ICBC	2	1	1	1
ABC	6	3	5	4
Bank of China	8	5	4	3
CCB	4	2	2	2
Bank of Communications	21	23	13	11

Data sources: September 19, 2016 Bloomberg database and the British banker magazine (the Banker) 2016 :7

Reform of rural credit cooperatives

- In June 2003, the State Council issued the direction on deepening the pilot program for the reform of rural credit cooperatives, and a new round of rural credit cooperatives reform began
- **The main problems faced by the reform:**
  - the lack of clarity of property rights： the imperfect corporate governance structure and the imperfect operational mechanism and internal control system
  - the management system： the management authority and responsibility needed to be further defined
  - a heavy historical burden： poor quality of assets, operating difficulties and potential risks
- **The goal of the reform:**
  - clear property rights
  - strengthen the restriction mechanism
  - strengthening the service function and appropriate support of local government
  - rural credit cooperatives are local financial institution to provide financial service to farmers, agriculture and rural economic development

Reform of rural credit cooperatives

- **The financial support policies:**
  - Adopts tax and financial policies to help release the historical burden of the rural credit cooperatives
  - People's Bank of China’s innovative policy of special central bank bills is the key to defuse financial risks
  - The special bill is issued by the People's Bank of China to rural credit cooperatives for the replacement half of the nonperforming loans. The amount is approved according to the 2002 financial regulatory data, tenor is 2 years (extended to 4-6 years), the annual interest rate of 1.89%. Financial support policies have been fully implemented with 169.9 billion RMB being issued to 2408 counties (cities)
  - PBC is in accordance with the guidance of classification, to prevent moral hazard
  - Establishment of motivate mechanism: **“Spend money to buy a mechanism” :** If rural credit cooperatives meet the requirment of PBC on internal governance system and capital adequacy, PBC will cash the special central bank bills

Recent Progress

- **CDB and the Import and Export Bank**
  - In July 2015, USD $48 billion and USD $45 billion worth of foreign exchange reserves were injected into the China Development Bank (CDB) and Export-Import Bank of China (EIBC) respectively, significantly improving their capital strength and risk control capability
  - The capital injection into the policy banks and the introduction of capital adequacy ratio requirements have enhanced the capital restraint on policy banks

- **Postal Savings Bank**
  - In December 2015, the Postal Savings Bank (PSB) successfully attracted ten domestic and foreign strategic investors, with a financing scale of 45.1 billion RMB, moving from a single shareholder to equity diversification
  - PSB was listed on H shares in September 2016
  - By introducing strategic investors and diversifying its shareholders, the reforms allowed the PSB to improve its corporate governance structure

Recent Progress

- **Agricultural Bank of China (ABC)**
  - With the approval of the State Council, the People's Bank of China issued a notice in April 2015, to make clear the ABC's rural finance department reform to expand to the whole country, in order to further promote the level of financial services in rural and county

- **Bank of Communications**
  - In June 2015, the Bank of Communication's reform schemes had been approved by the State Council, from the perspective of improving the ownership structure, corporate governance, deepening internal reform and strengthen external supervision
  - Mixed-ownership reform: employee stock ownership plan

V Regulatory Implementation

Micro-prudential Supervision

- The first stage: from 1978 to 1992, marked by administrative regulation and management of credit scale
  - Since January 1984, the PBC has solely functioned as a central bank. Credit funds management was implemented under a “unitary plan, divided funds, real credit and deposit, mutual finance” principle
  - Credit funds at each professional bank had to be included in the national comprehensive credit plan
  - This stage was in fact a planning phase, with the PBC in charge of balancing, appraising, and rectifying the credit funds
- The second stage, from 1992 to 2006, with the establishment of the PBC, CSRC, CIRC, and CBRC
  - A prudential regulatory system gradually formed, which included risk management, funds regulation, and internal management
  - In the early phase, the management focused on asset-liability ratio management and loan-deposit ratio
  - Since 2000, risk management has shifted into three-risk management, which considers credit risk, market risk, and operation risk
  - With the implementation of the Basel New Capital Agreement, the idea of capital management was introduced into commercial bank management

Micro-prudential Supervision

- The third stage, after the subprime crisis in 2007 and with the implementation of Basel III
  - CBRC formed a new framework—"Chinese Basel III supervision", which used "dynamic capital, dynamic provision, leverage rate, and liquidity" as its four new regulatory tools
  - The first tier capital adequacy ratio of commercial banks was raised from 4% to 6%, with the capital adequacy ratio maintained at 8%
  - CBRC extracted 2.5% retained capital and set a 1% additional capital requirement for systematically critical banks; introduced a dynamic provision rate to control management risk, and introduced a leverage rate as a regulatory index, of no less than 4%; introduced a liquidity coverage rate and gross stable finance ratio
- Through the three stages, the micro-prudential supervision framework was gradually built

Macro-prudential Policy

- In 2010, the PBC implemented a macro-prudential regulation strategy
- In 2011, a mechanism for the dynamic adjustment of differential reserves and consensus loan management was established to reduce systematic financial risk
- In 2016, the mechanism was updated to the **macro-prudential assessment system (MPA),** which is an important component of the macro-prudential regulatory framework
  - The MPA assesses **seven aspects** of the banking industry and financial institutions, including capital and leverage, balance, liquidity, price fixing, quality of assets, risk of cross-border finance, implementation of credit policy
  - The aim is to enhance self-regulation and self-restraint, which helps with the prudent operation of financial institutions
- **The MPA has been gradually improved:**
  - In 2017, PBC included underlying assets of wealth management product in MPA to control shadow banking activites of commercial banks
  - In 2018, the MPA included inter-bank deposit (CD) in the evaluation of inter-bank liability to encourage financial institutions to enhance liquidity management, lower inter-bank business, and use stable funding sources to develop their business
- Since 2017, with the establishment of the two-pillar policy, i.e., macro-prudential policy and monetary policy, the tasks of maintaining the stability of monetary value and financial stability are better integrated
  - Monetary policy is to exercise macro control over monetary value stability and economic growth
  - Macro-prudential policy focuses on the stability of the financial system itself and the control of systematic risk

Thanks