Opening a creaky door to growth

# A Revolution in Chinese Banking

**Despite enormous growth, Chinese banks face both old challenges and increasing foreign competition. In December 2006, their market will be fully opened to foreign invested banks, as the Chinese authorities have announced. Though Chinese banks are revolutionizing their management systems, implementing best practices must take into account the industry's specific structure and requirements.**


The Chinese banking industry is a key agent of China's economic success. The country's banks have been rapidly expanding during the past several years, benefiting from a fast-growing economy and more flexible monetary policy. However, the management systems of many Chinese banks do not yet meet international standards. Implementing international best practices can be successful only if the characteristics of the Chinese banking system are carefully considered.

The Chinese banking industry includes five main groups:

- Four large state-owned commercial banks
- Three policy lending banks (government-owned development banks for public investments)
- Eleven joint-stock commercial banks
- Numerous city commercial banks and credit cooperatives
- Existing and future foreign financial institutions

The four large state-owned commercial banks are among the biggest banks worldwide, with total assets of 19,657.97 billion renminbi (about U.S.$2,453 billion), an extensive branch network, and more than 700,000 employees. However, their share of total assets has fallen from 77 percent 10 years ago to 52.5 percent today.

By striving continually during recent years, the Chinese banking industry has achieved a lot: Asset quality has improved; management and internal control have been enhanced; and many banks have achieved preliminary centralization of decision-making management and internal reporting systems. Nevertheless, Chinese banks still face dozens of historical problems. Their solvency remains very weak; profitability is poor; and the level of nonperforming loans remains high compared with international standards.

The following three cases show the problems in detail.

**Nonperforming loans**

First comes the high rate of nonperforming loans. According to the central financial supervisory authority, the China Banking Regulatory Commission (CBRC), nonperforming loans by state-owned commercial banks amounted to 1,072.48 billion renminbi in 2005 (about U.S.$134 billion), which is 10.49 percent of total loans. Joint-stock commercial banks had 147.18 billion renminbi (about U.S.$18 billion) in nonperforming loans (4.22 percent of total); the other Chinese commercial banks together hold 1,313.36 billion renminbi (about U.S.$164 billion, 8.61 percent of total).

The causes are easily identified: In the past, state-owned banks were the primary funding source for large, state-owned enterprises. As in other centrally planned economies, budget constraints were often soft. This led to the large concentration of nonperforming loans in state-owned banks (also in previously state-owned but now privatized banks). Banks and the government are aware of this problem. They launched several major structural reforms of state-owned banks in 2005, including opening them to foreign investment.

**Shortage of capital; regulatory challenges**

The second historical problem is the general shortage of capital and the challenges from new supervisory regulations, such as Basel II. According to CBRC, the capital shortage of China's commercial banks is above 2,000 billion renminbi (about U.S.$250 billion) under the latest Basel I standard. The new regulations increase the pressure for change. According to the CBRC time schedule, all Chinese banks must fulfill Basel I from 2006 onwards; Basel II will be fully valid for Chinese banks by 2012. However, the problems mentioned above create difficult obstacles for achieving the CBRC schedule.

**Management concerns**

The third historical problem includes the manifold defects in internal management, such as credit evaluation, credit-extension systems, risk management, and reporting.

The quality and skills of employees must also be improved. Too many divisions and employees in the four state-owned commercial banks cause inefficient administration and burden the banks' operations. Therefore, they need flexible, market-oriented management systems that both centralize and unify ledger accounts, management accounting, and risk management. Some joint-stock commercial banks have already adopted standard software, such as that of SAP, as a human resources or financial management platform, which enables profitability and risk management, accounting centralization, flow standardization, total cost management, and enhanced internal control.

**New pressures**

With the opening of the market this coming December, the Chinese banking industry will face intense competition with foreign banks. This situation makes the implementation of integrated bank management and controlling systems crucial for future growth. Otherwise, the Chinese banking system could become an obstruction to China's continuous economic development and stability.

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