

China's Financial Reforms: Why Dysfunctional Banking Survives

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China Misreported

A well-known British economist claimed that by 2009, China's banks had already "... made enormous strides in reform and deregulation. They have emerged relatively unscathed from the global banking epidemic ... and the largest of them stand alongside the giants of global banking as first among equals".

Crisis Highlighted

- Deputy Prime Minister Wang Qishan (*CD 30/11/11*)
“... the country witnessed a 10-fold bank lending increase in 2009 from the average from 1998 to 2002... this unbridled lending expansion has brought the country’s economy and its financial sector to a very dangerous position. For example, the inflated real estate bubbles and the huge credit risks that domestic commercial banks, the country's local financing platforms as well as the non-governmental credit market are exposed to, if not effectively controlled, could become triggers for a destructive financial crisis”.

Dysfunctional System

- 2009: “The correlation between efficiency and profitability is close to zero for Chinese banks”. (IMF WP/09/170 August 2009)
- 2006-10: World Bank “*Doing Business*” surveys show little improvement in China’s banking performance.
- 2005: Many PRC bank branches too incompetent to be allowed more than “one or two loan businesses per year”. (PBOC)

Dysfunctional Banking

- 2010: Agricultural Bank of China's IPO was world's largest ever
- 2008: IPO made possible by ABC state bailout of USD117 bn
- 2003-09: "average default rate" for farm loans was 45% (ICBC, CD 05/05/11)

Two Sources of Dysfunction

In 2007, PBOC Governor repeated reform calls made in 1978, 1979 and 1997 to halt the two main causes of the banks' chronic NPLs:

- “*Policy lending*”: Banks follow state directives and planning targets in making loans regardless of borrowers' credit standing.
- “*Relationship-based lending*”: A borrower's official or Party status is the overriding factor in making loan decisions. (Governor, PBOC 05/12/07)

Past Reforms Shelved 2008-09

- US\$586bn stimulus package funded:
 - CPG, 30%; LGs (& private), 70%
 - LGs: no legal borrowing powers
- “Policy”/“Relationship” lending returns:
 - NDRC: law can be ignored
 - MoF: public land to be sold if necessary

Discipline Disappears

Local gov't bank borrowings rose 70% in 2009, equal to 20% GDP

- For LGs: “an unprecedented windfall of funding opportunities for...pet local projects”.
- For banks: “all personal responsibility for lending decisions” eliminated. (Prof. C. Wong, *OECD* 6-7/06/11)

2008-09 Crisis Fallout

- 2012: PRC left with “asset bubbles, inflation and redundant construction” (*CD 23/07/12*)
- 2011: To ease strain on bank reserves USD438 bn LG borrowings “reclassified”, equivalent to:
 - 1/3rd of 2009 LG bank borrowings; or
 - 75% of original stimulus package (*CD 15/08/11*)
- 2010: “Questionable” LG loans equal to 4% GDP
- 2009: LG borrowings “beyond their repayment capacity” causing immediate “systemic risks” to the financial system (*BoC, NCNA 9/11/09*)

Fraud: Push and Pull

- Lending under political pressure or for personal gain undermines credit quality.
- Banks need to camouflage “political” and “personal” loans and their defaults.
- Banks will try to cover rising losses through higher-margin but riskier loans.
- Fraudulent accounting is inevitable to prevent a run on the bank.

Management Defects Rampant

- 2012: “Nationwide crackdown on irregular banking”. Major target “to curb corruption” caused by “dictatorship” of key officials. (NCNA 06/04/12, 05/07/12)
- 2011: Top 5 banks “misallocated” USD8.9bn in loans, in defiance of credit and authorisation rules. (NAO, NCNA 27/06/11)
- 2010: ICBC & Citic “chaotic” management “violated financial regulations”. (NCNA 01/06/12)

High-level Crime Endemic

- 2002-10: anti-money laundering drive: 100+ cases totalling USD30bn (NCNA 23/11/10)
- CDB: exVP death penalty for USD1.76 mn bribes. (NCNA 09/09/10)
- BoC: exDepMgr Heilongjiang stole USD158mn in 2000-04 (NCNA 30/01/12)
- ICBC (HK): two staff took USD700,000 from client loaned USD256mn. (SCMP 25/08/11)

Banking & Deng's Reforms

Modernisation's goals:

- to underwrite financial costs of the shift from central planning to market forces from 1978; and
- to create the financial infrastructure to support high and sustained growth..

Regulatory reforms:

- to establish professional banking standards; and
- to give regulators and loan officers autonomy.

Recreating Commercial Banking

- 1980: a new “L/C” to cover contracts and market transactions among cities and provinces to replace planned allocation.
- 1984: cheques re-introduced on local and tentative basis.
- 1986: first inter-branch, inter-city phone transfers by ICBC (instead of cash)
- Early 1990s: head offices still had no effective control over branch activities.

Banks Pay for Deng's Reforms

- From 1978, allocation of funds, plant and sites, raw materials to public sector halted. But price controls continued.
- In 1981, factories suddenly lost their funds and raw materials and stopped production.
- In 1990, industrial enterprises still suffered substantial losses “because their products could find no market” especially exports.
- **Banks were expected to prevent enterprises from going bankrupt with unrepayable loans.**

LGs Left to Plug the Gaps

- 1984-8: CPG slashed investment role. LGs left to fill gap, despite limited legal revenue sources.
- 1990s: Illegal bank funding grows (mainly via SPVs) as LGs' industrial projects falter.
- 2000s: National campaigns to halt illegal borrowings and land deals.
- 2005: These loans said to be “a menace to the country's fiscal system”, and beyond “repayment capabilities”.

Local Government: Illegal & Insolvent

LGs fund 79% of state spending but have 47% of state revenues – a world record.

- 2011: first “rudimentary mechanism” to fund county governments
- 2011: First national rural land registration
- 2011-12: NPC rejects law empowering LG bond issues because LGs “lack transparency and proper monitoring” and “repayment abilities” are doubtful. *(CD 27/06/12)*

Legal Loopholes

- 1993-99: CCP disputes over role of “shareholders, directors, management and employees” in running enterprises.
- 2007: first legal recognition of private property
- 2010: first “clear regulations” for “budget management and supervision of government funds”
- 2009-11: drive to end Party/state agencies' illegal bank accounts netted USD4bn. (NCNA 25/08/10, 14/12/11)

PRC Regulatory Model

- Market liberalisation has been PRC policy since 1978.
- PBOC and CBRC see the current global regulatory culture as the way forward.
- But PRC leaders never intended capitalism to take over.
- The state still decides development priorities and allocates resources.

A Return to Reforms

Threat to financial stability recognised
2010:

- Banks criticised for “unscrupulous and unhealthy” conduct; illegal borrowings to be repaid. In future, “supervisory authorities must... resist any relaxation of supervisory and regulatory standards”.
- “Supervisory practices should be invasive and interactive”.

The State vs the Banks

- Bank regulators want firms left free to make own business plans OECD-style.
- CPG ordered lending cuts 2009 for excessive/outdated capacity and polluters.
- Motor industry dispute official statistics.
- Bankers' dilemma: state policies vs bank profits from firms where shareholders come first.

Future Pressures

- 2011-15: affordable housing
 - 36 mn new units (20% of current stock)
 - cost USD770bn, funded mainly by LGFVs/bank loans
- 2012-15: highly controversial LG “stimulus packages”, e.g.:
 - Guizhou: USD572bn
 - Zhejiang: USD186bn
 - Tianjin & Chongqing: USD236bn each
 - Changsha: USD131bn

Global Trade, Local Banking

- 2011: 436,800 (mid-2012) “foreign-funded enterprises” generated
 - 50+% foreign trade
 - 25% of industrial output
 - 20% of total tax revenue
 - one in every 7 jobs (State Councillor Ma Kai, CD 09/09/12)
- Foreign banks accounted for 2% per cent of total PRC bank assets.

For full data and sources, see:

1. *Reluctant Regulators: How the West Created and China Survived the Global Financial Crisis* (2011)
2. 嚴防金融海嘯重臨：香港監管文化的啟示 (2012)
3. “China’s LGFV Crisis 2011: The Conflict between Local Autonomy, National Interest and Financial Reforms”, *HKIMR Working Paper No. 03/2012*, January 2012