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REFORMING THE STATE OWNED BANKS AND THE DEVELOPMENT OF FINANCIAL MARKETS IN CHINA

Lecture at the Norwegian School of
Economics and Business Administration

Disposition

1. Briefly on history in general
2. History of banking and finance
3. Strategic Partners – what is in it for Chinese Banks?
4. Chinese Banks – what is in it for Strategic Partners?

1. Briefly on history in general

- 1949: Mao carries the day.
- Compare to England in July 1945:
 - Churchill won the war – but lost the election (to Attlee)
- 1949—1976: A disastrous period.
 - Great Leap Forward
 - Cultural Revolution
- 1976—1978: Who will succeed Mao?
 - Deng wins out

June 1981, The Party states:

“Practice has shown that the “Great Cultural Revolution” did not in fact institute a revolution or social progress in any sense, or could possibly have done so.... History has shown that the “Great Cultural Revolution”.... led to domestic turmoil and brought catastrophe to the party, the state, and the whole people...”

- Deng, a pragmatic: “Seeking truth from facts”
 - The color of the cat does not matter as long as it catches mice.
 - Some regions have to get rich first
 - Getting rich is glorious
- General Point: Economic development gets priority

- 1989: Tianaman Square tragedy
- 1997: Deng dies. Jiang Zemin takes over
- 2001: Zhu Rongij gets China into WTO – after 15 years of negotiations
- 2003: Jiang and Zhu step back, gradually, and Hu Jintao and Wen Jiabao take over
- December 2006: Foreign banks are free to establish themselves and compete with Chinese banks (WTO)

2. History of banking and finance

1979: Agricultural Bank of China, and Bank of China are spinned off of the, at that time, monobank (Peoples Bank of China, or PBC)

China Construction Bank (CCB) likewise is spun off form Ministry of Finance

1984: ICBC (the largest SCB) is established, based upon assets and liabilities lifted out of PBC which becomes a central bank.

Thus, a two-tier banking system is established.

- 1990: Shanghai and Shenzhen stock exchanges are established. Two third of all stocks owned by the state
- 1995: The RMB is devalued and more importantly a unified system for the exchange rate is adopted, at 8,28 RMB to the dollar
- RMB convertible for transactions on the current account
- 1996: Chinese may have dollar-accounts in banks. But foreigners cannot freely buy RMBs. Foreign Direct Investments (FDIs), however, are favourably treated, i.e., convertibility also for certain transactions on the capital account.

- 1997: Asian crises starts, 2nd of July in Thailand
- China maintains her peg to the dollar while most other currencies start to float downwards, and quite sharply so
- HK\$ also retains her peg to the USD, 7,78 HK\$ to one USD
- 1999: Four AMCs are created, to relieve SCBs of bad loans. 170 billion USD of bad loans taken over by AMCs. Recovered about 20 per cent of face value of 60 per cent of the loans.
 - Dec 2001: Goldman Sachs buys NPLs of 2 billion RMBs from Huarong, the AMC of ICBC.

- Jan. 2004: PBC puts 22,5 billion USD (in dollars) into both CCB and into BoC
- Few months later they are both transformed into joint stock companies. Stocks are owned by Central Huijin Investment Ltd (cf. Statens Bankinvesteringsfond in Norway)
- 2004: NPLs in CCB down to 3,9 per cent. Return on equity for CCB in 2004 was 25 per cent. The last 8 percentage points because tax claims by the State was abandoned

- August 2004: HBCS buys 19,9 per cent of Bank of Communication (1,7 billion USD), which is the fifth largest bank in China.

- March 2005: CEO of CCB leaves. Corruption. As the former boss who got 12 years in prison for corruption in 2003. New CEO, Mr. Guo, discovers that the Party Committee in CCB does decide on most issues. The Board has been sidelined.
- June 2005: Bank of America and Temasek buy 9 and 5,1 per cent respectively of CCB. Priced at 1,15 of book value.
- October 2005: CCB listed in Hong Kong. Priced at 68 billion USD – more than American Express. Price is close to twice book value. Authorities are being criticised for selling out too cheaply to B of A and Temasek

3. Strategic Partners – what is in it for Chinese Banks?

- “Strategic foreign partners have the potential to improve virtually every dimension of Chinese banks’ performance” (Hope & Hu)
- B of A and Temasek Strategic Partners (SPs) for CCB before CCB goes on the Stock Exchange. Why?
 - Reputation
 - Due diligence
 - Prestige
 - Better price at the IPO.

SPs to improve Corporate Governance – in the widest sense of the word

- Expertise in credit analyses
- Expertise in risk management
- Improve marketing
- Introduce new products, like credit cards, and consumer finance more generally
- Introduce new technology
- Supply expertise personnel
- Training of local personnel

Ultimate goal for Chinese authorities: Make sure that *existing stocks* of NPLs is not being followed up by a continuous *new flows* of new NPLs.

4. Chinese Banks – what is in it for Strategic Partners?

It's the profits, stupid!

- Economic growth and great market opportunities
- Loan growth and expanding into new markets, e.g., consumer finance
- Very good margins are in the interest of the authorities. Why? So that Chinese banks can handle existing NPLs with minimal infusion of new capital
- Secure distribution channels
- Politically – early-mover advantage?

Key concerns: Asset quality

- Absence of credit culture
- Remain a minority stake holder
- Board structure not conducive to checks and balances
- Credit decisions based on relationships
- Cash flow analysis yet to be adopted
- Legal structure
- Exit

Hope & Hu (2005):

“It remains to be seen whether foreign strategic investments would ultimately work”