China and Its “Long March” Toward a Modern Banking System

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I. Introduction

China, the ancient oriental empire, opened its door to the outside world in the first half of the nineteenth century. Modern banking was introduced at that time to satisfy the financial needs of increasing trade business between China and the western world. So till now China has had long experience with the banking system. But influenced by several severe social transitions in the past two centuries, China’s modern banking system experienced different development directions and is now still at a premature stage.

For the recent 25 years, recognizing the need to merge into the global system and to sustain its domestic development, China has conducted comprehensive reforms in its banking sector to adopt a modern banking system consistent with evolving and heightening international prudential, operational, and anti-money laundering and anti-terrorism financing standards, along with the liberalization and openness aims engendered by the move toward a robust “socialist market economy” on a sustainable basis and the embrace of the WTO requirements.

The reforms already conducted in the banking sector are extensive in scope and have received impressive achievements. But China still faces numerous challenges in accomplishing its goal. Besides, as an emerging economic power with the inevitable evolution of the Chinese Yuan into a major international currency but at the same time still being a developing country facing a lot of disparities and development needs, China encounters a more complex situation to balance the conflicting functions of its banking sector when designing the reform schemes. The banking reform process is still in progress and China is just on the half way towards its ultimate aim.

II. Brief History of China Modern Banking System

China is an old civilized country but mysterious to people in the western world.

Modern banks landed in China shortly after the First Opium War in which this ancient Middle Kingdom was defeated for the first time by the west. Since then, China has been on its way towards the establishment of a modern banking system. We can divide the whole development history into four periods:

(1) 1845 -1896

This period can be characterized as a foreign dominated banking system. In 1845, the Oriental Bank Corporation, which was a British bank, opened a branch in Canton. It is the first modern banking institution in China. After that, several European and American Banks set up branches in most of the major commercial centers all over China. Some western banks even started business in this country. For example, Hong Kong Shanghai Banking Corporation (HSBC) was established in 1865 to finance the growing trade between China and Europe. However, there were no Chinese banks established during this period. The western capitals exclusively dominated the Chinese banking sector.

(2) 1896 -1949

This period can be characterized as a mixed but undeveloped modern banking system. In 1896 China Merchants Bank, the first Chinese modern bank was established in Shanghai by China Merchants Group which was a governmental business entity. From that time, a mixed modern banking system began to develop. This system was composed of state-owned banks, private banks and foreign banks. Both Chinese and foreign capitals were active in the banking industry.

(3) 1949 -1978

This period can be characterized as a typical socialist banking system. In 1949, Mao's army defeated Kuo Min Tang and drove it to Taiwan. The new regime, People's Republic of China, copied economic systems of the Soviet Union. The national economy was managed through highly centralized plans. There was no exception in the banking sector. During this period, only three state-owned banks existed in the whole country, namely, People's Bank of China, China Construction Bank, and Bank of China. People’s Bank of China was the central bank. But except the note-issuing function, there were no other differences between the central bank and the other two banks. All the three banks were tools of the central government for the implementation of economic plans. To the ordinary Chinese people, what banks meant to them was just a place where they could deposit money and receive interests.

(4) 1978 - Present

This period can be characterized as a gradually reforming banking system. After Mao’s death, his successor, Deng Xiaoping reversed course and adopted the reformation and opening policy. Extensive reforms have been carried through in all economic areas, some of which achieved impressive success. Under such a background, the banking system of China has undertaken significant changes since 1978. The aim is to change the old banking system of soviet style into the new market-oriented one. Besides the restructuring of the state-owned banking sector, main measures in the banking reform process include: reconstruction of the central bank; cultivating all kinds of banks to activate the banking sector; and opening domestic banking market to foreign competitors.

III. Reform Process of the Banking System

A. Reconstruction of the Central Bank

Since 1949, People’s Bank of China (PBC) has been the central bank of the Chinese government. But before 1984, PBC also conducted commercial banking businesses, like taking deposits and granting loans. The reform of PBC started at the end of 1970s and was completed by three main steps:

1 the Establishment of Agricultural Bank of China

At the end of 1970s, PBC was the largest one among the three state-owned banks. The first step of the PBC reformation was the gradual separation of its commercial banking sector. In 1979 part of PBC became Agricultural Bank of China, which at that time was a special purpose state-owned bank to serve for the country’s vast rural areas.

2 the Establishment of Industrial and Commercial Bank of China

In 1984, the rest commercial banking sector of PBC was separated and became Industrial and Commercial Bank of China. This new bank succeeded all PBC's assets and businesses in cities all over the country. So there was a separation of markets between Agricultural Bank of China and Industrial and Commercial Bank of China.

As a result, PBC became a specialized central bank for the first time in its history. It's one of the ministerial level agencies in the central government and directly subordinated to the State Council. But at that time, PBC was both the monetary policy maker and the regulator of the whole financial industry.

3 the Establishment of Three Regulatory Commissions

In order to realize the specialized regulation and supervision of the three sectors of the financial industry, i.e., securities, insurance, and banking, China has consecutively established three specialized regulatory commissions since the early 1990s. In 1992, China Securities Regulatory Commission was set up and took charge of the regulatory and supervisory responsibilities of the securities industry which was formerly within the power of the PBC. In 1998, the regulatory and supervisory responsibilities of the insurance industry were transferred from PBC to China Insurance Regulatory Commission. In 2003 China Banking Regulatory Commission was established to take charge of the banking regulation

So, since 2003 all the regulatory powers have been transferred to the specialized regulatory commissions. PBC has only retained the power of note-issuing and monetary policy. But the State Administration of Foreign Exchange is closely related to it. So PBC can exert great impacts on the country's foreign exchange policy. Besides, PBC manages China's gold reserves and also has the regulatory power over the gold market.

B. Emergence of Different Types of Banks

Before 1985, the four state-owned banks (the "Big Four"), namely Industrial and

Commercial Bank of China, Agricultural Bank of China, Bank of China, and China Construction Bank monopolized the whole banking industry. Although the Big Four still dominated the market, more and more competitors have entered into the market since 1985. After 20 years development, there are several kinds of banks existing in China's banking market. But listing the first one of all these types of banks will still help illustrate this development process.

- In 1985 Xiamen International Bank was established as the first Sino-foreign joint venture bank. Its foreign investors included the Asian Development Bank, as well as commercial banks from the U.S. and Japan.

- In 1987 Bank of Communications was established in Shanghai as the first share-holding commercial bank. Though it was also controlled by the government, its share-holding ownership structure was brand new at that time and differentiated it from the "Big Four."

- In 1987 China Merchants Bank was established in Shenzhen, a young city developed after 1978 adjacent to Hong Kong and acting as the test field of China's reform and opening policy, as the first share-holding commercial bank whose stake holders were all enterprises.

- In 1994, three policy banks, namely China Development Bank, Export-Import Bank of China, and Agricultural Development Bank of China, were established. Before then, the "Big Four" bore the burden of the policy loans. As the policy loans were operated pursuant to the executive demands from the government instead of the market rules of the commercial world, the continuance of this obligation obviously did not conform to the reform aim of commercialization of the "Big Four." As a result, three policy banks, which directly subordinate to the State Council, came into birth to take over the obligation of policy loans from the "Big Four." Their aim was not based on the market but to carry out the government's macro economic functions.

- In 1995 Shenzhen Urban Commercial Bank was established as the first urban commercial bank.

- In 2001 Zhangjiagang Rural Commercial Bank was established as the first rural commercial bank.
- In 2004 Huaxi Rural Cooperative Bank established as the first rural cooperative bank.

The precursor of these urban and rural commercial banks and rural cooperative banks was the urban and rural credit cooperatives. Today, there are still thousands of such kinds of credit cooperatives all over the country. After the restructuring, the former cooperatives will be governed by the Commercial Bank Law and receive higher standards of operation and regulation. It will greatly improve the operational situation of these small financial institutions and lower the potential market and credit risks.

After 20 years' reform, the current structure of China's banking system can be listed as follows. All the numbers are the most recent available at present, most of which were updated at the end of 2005.

- 4 State-owned Commercial Banks, 1 of which get listed
- 3 State Policy Banks
- 12 Share-holding Commercial Banks, 6 of which get listed
- 120 Urban Commercial Banks
- 11 Rural Commercial Banks
- 48 Rural Cooperative Banks
- Thousands of Urban and Rural Credit Cooperatives
- Foreign Banks: 238 subsidiaries or branches of 71 banks from 20 countries; 238 representative offices of 173 banks from 40 countries
- Other Banking Institutions (financial leasing companies, trust and investment companies, finance companies, etc.)

C. Opening the Domestic Banking Market to Foreign Competitors

Both Reform and Opening are two equally indispensable elements of Deng's new policy. The opening process of China's banking industry to the outside world kept pace with the reform and also began at the end of the 1970s. The first foreign banking institution came from China's east neighbor. In 1979, the Export-Import Bank of Japan (JEXIM) set up the first foreign bank representative office in Beijing. Not surprisingly, the first substantial investment in China's banking industry was from Hong Kong. In 1982, Hong Kong Nanyang Commercial Bank became the first foreign bank which had subsidiary in mainland China. In 1985 all the five special economic zones, namely Shenzhen, Zhuhai, Xiamen, Shantou and Hainan Island were open to foreign banks. The opening coverage then gradually extended to the 14 port cities in the east coast. During the following a few years, foreign banks were allowed to establish subsidiaries and branches in more and more Chinese major cities, including many inland provincial capital cities. This process happened to parallel with China's GATT, and later WTO accession negotiations.

According to the commitment China made when it acceded into WTO in November 2001, China would gradually open its banking sector during a five years' grace period starting from accession. During this period the opening scope, from the perspective of both territory and business, would be expanding year by year pursuant to the opening schedule in China's commitment.

Besides the establishment of branches and subsidiaries in major cities of China, a prominent feature of the foreign banks' expansion is the active participation in Chinese banks' shareholding reforms. International financial groups have made extensive investment in all kinds of Chinese banks, from the "Big Four" to the local urban banks. Among these investments, three of them are the most eye-catching and can be regarded as the landmarks.

The first one happened in August 2004 when HSBC invested 14.46 billion RMB (1.75 billion U.S. dollars) to acquire Bank of Communication's 19.9% stake. Bank of

Communication at that time was China’s fifth largest commercial bank but the largest shareholding bank whose controlling shareholder was the Ministry of Finance. Before that transaction, foreign investments were only approved in the relatively small shareholding banks and local urban banks. So, this transaction expressed the welcome attitude of the Chinese government towards the participation of foreign capitals in large state controlled banks.

The second landmark was the strategic investments in the “Big Four” by foreign investors. Bank of America and Temasek Holdings purchased respectively 9% and 5.1% of China Construction Bank’s stakes. A consortium led by Royal Bank of Scotland purchased Bank of China’s 10% stake. There is still a pending purchase of Industrial and Commercial Bank of China’s 10% stake by a consortium led by Goldman Sachs. These transactions broke the ice in China’s state-owned banking sector. They are vital for the reform of state-owned banks and will be discussed later in detail.

The third landmark is still pending. A consortium led by the financial behemoth Citibank aimed to pay 3 billion U.S. dollars to acquire 85% stake in Guangdong Development Bank (GDB). If the transaction were approved by the Chinese government, Citibank would own 40-45% of GDB’s stake. According to the current law, foreign investment in the domestic Chinese financial institution cannot exceed 20% of the whole stake for a single investor. However, if the total investment in a non public listing financial institution by a consortium exceeds 25%, this financial institution will be regulated as a foreign one. Were the transaction of Citibank approved, GDB would turn to a foreign bank under the Chinese law. But if strictly analyzed, no matter the total investments by a consortium, in any situation the investment by a single investor cannot exceed 20%. This is disputable and there are no official clarification on this issue. But a senior official of China Banking Supervision Commission (CBRC) has admitted that CBRC would raise the 20% investment cap for the single foreign investor in the near future. This change may become true before the end of the grace period in China’s WTO accession commitment.

The last year of this grace period is 2006. So at the end of this year, foreign banking institutions will enjoy the full access to the China's banking market. There will be no restrictions on both territory and business areas. Similar opening also happens in the securities and insurance sectors. China's modern financial market will embrace a new era in its short history. A more globally involved Chinese financial market is a double-edged sword for China's economic growth. Both opportunities and risks are hidden.

IV. Restructuring of State-owned Commercial Banks

A. Brief Introduction of the "Big Four"

Although the banking market has already been open for the private and foreign capitals, the "Big Four" still dominate the banking industry. They have the most complete business network all over the country, both the cities and the rural areas, as well as extensive global presence. The "Big Four" totally have an overwhelming 85% of the market share and hold 65% of all deposits from residents.

Bank of China

Advantage: overseas network and international experiences

Established in 1912, Bank of China is the oldest bank in China now. It is also the most prestigious Chinese bank in the world financial market. It is the first and the only Chinese bank that has presence in all major continents. At present the bank offers financial services through its global network of over 560 overseas offices in 25 countries and regions. In Hong Kong and Macao, Bank of China is one of the local note-issuing banks.

Industrial and Commercial Bank of China (ICBC)

Advantage: the largest scale of financial assets and domestic RMB business

ICBC has ranked the first in Chinese financial market for many indexes such as total assets, total capital, core capital and operating profit, etc. Through its over 21,000 domestic branches, 100 overseas branches and up to a thousand correspondent banks, ICBC provides service for over 8 million corporate clients and over 100 million individual clients. In 2004, the RMB settlement volume of ICBC was 150 trillion RMB, accounting for 45% in the market.

Agricultural Bank of China

Advantage: the most extensive rural network

Agricultural Bank of China boasts its most extensive outlets covering the huge rural areas in this country. With 31,000 branches and banking offices on the boundless land of China, one can feel the existence of Agricultural Bank everywhere. The business scope of this bank has developed from the original rural credit and settlement to a wide range of financial businesses with RMB and foreign currencies.

China Construction Bank

Advantage: the first “Big Four” bank publicly listed overseas

China Construction Bank has been one of the oldest state-owned banks since 1949. Because of its relatively small size, it became the test target for the market-oriented reform of the “Big Four”. At the end of 2003, a capital injection of 22.5 billion U.S. dollars was received from the central government to enhance its financial condition and competitiveness, and qualify its overseas listing. In October 2005, China Construction Bank was successfully listed on the Hong Kong Stock Exchanges, which raised 8 billion U.S. dollars from foreign investors for 12% of its shares.

B. Influence of Evolving International Standards

International banking practices and standards cannot be ignored during the opening process of Chinese banking industry. Chinese banks have to accept the game rules already set up by their western competitors. Modern international banking standards, especially those issued by the Basel Committee, have great influence on China’s banking reforms. In fact, one of the incentives to restructure the “Big Four” is to make them satisfy the 8% capital adequacy requirement in Basel Accord I and qualify their competition ability in the international arena.

Although the government never published the real number, it was estimated that the non-performing assets ratio of the "Big Four" was as high as 40%-50% before the restructuring. As most of the business clients of the "Big Four" were state-owned enterprises (SOEs), the stagnancy and deterioration of SOEs' operation from the early 1990s resulted in huge amount of non-performing loans. At the same time, with the opening of the banking sector, as well as the whole national economy, to the world, the "Big Four" were the only hope to prevent the domination of the banking market by foreign competitors. So a substantial reform of the "Big Four" was inevitable in the late 1990s.

The restructuring of the "Big Four" was designed to include three steps: optimization of capital structure; reformation of the old ownership; and public list in overseas stock market. This is an ambitious plan for this country's gigantic state-owned banking sector. Considering the risks of reform, two of the "Big Four" banks, China Construction Bank and Bank of China, have been chosen to do the test. The other two fellows will closely follow their steps.

C. Optimization of Capital Structure

The "Big Four" have long suffered from non-performing loans (NPLs), which is a result of decades of policy-directed lending to loss-making state-owned enterprises under the planned economy. The establishment of three policy banks partly resolved this problem. In the past few years, the Chinese government has adopted another two major measures to deal with the NPLs:

(a) Striping off of the NPL from the "Big Four"

Before the reform, NPLs were the nightmare of the "Big Four". Dealing with them consumed a lot of resources of the banks. In 1999, four asset management companies, namely Great Wall, Orient, Cinda, and Huarong, were established to take over the NPLs of the "Big Four". The four asset management companies were special vehicles to resolve the NPL problem. Their establishment aimed to guard against and dissolve financial risks, deepen financial and banking system reform, and sharpen international competitive edge of the state-owned commercial banks.

Typically, they purchased, managed and disposed the non-performing assets stripped off from the state-owned commercial banks. The most common disposal means was to sell NPLs in packages at a very low price. The international investment banks were always interested in these sales. Merrill Lynch, Morgan Stanley, Lehman Brothers, Citigroup were all active participators in this process.

At the beginning, each asset management company was responsible for a corresponding “Big Four” bank. But nowadays the asset management companies also can compete with each other and provide service for all the “Big Four” banks, as well as other commercial banks. The “Big Four” benefited from this reform. Since 1999, over 1,400 billion RMB non-performing loans have been stripped off from the “Big Four” and the striping process is still continuing.

(b) Capital Injection from the Foreign Exchange Reserves

The second measure adopted by the Chinese government to resolve the NPL problem was the capital injection from the country’s large foreign exchange reserves. China owns the second largest foreign exchange reserve in the world, a pool of over 818.9 billion U.S. dollars at the end of 2005. In December 2003, the central government, through a newly established special purpose corporation Huijin, injected 22.5 billion U.S. dollars to the capital funds of China Construction Bank and another 22.5 billion to that of Bank of China. In April 2005, 15 billion U.S. dollars were injected to Industrial and Commercial Bank of China. The injection of foreign exchange funds enabled these three banks to meet the 8% capital adequacy requirement in Basel Accord I. Bank of China boasted a capital adequacy rate of 8.01% while China Construction Bank’s rate was 10.08% and Industrial and Commercial Bank of China 10.26%.

D. Reform of the Ownership

Both the striping of NPLs and the capital injection just resolved the problem temporarily. What the “Big Four” need is a fundamental reform in their ownership system and reasonable corporate governance under the new ownership structure.

Before reform, the “Big Four” were 100% state-owned commercial banks. They have all the same disadvantages and defects as other state owned enterprises. So the aim of the restructuring is to change the old state ownership to a flexible share-holding system.

(a) China Construction Bank (CCB)

In 2004, the original CCB was split into two parts, with one part being the China Construction Bank Share-Holding Corporation and the other one Jianyin Investment Corporation. Most of the assets of the old China Construction Bank remained in the share-holding corporation. At the beginning, all of the share-holders were state companies. Central Huijin, the special-purpose government company for the capital injection purpose, became the controlling shareholder in China Construction Bank Share-holding Corporation with an 85.23% stake. Jianyin Investment held a 10.65% stake. Steel giant Shanghai Baosteel and utility giant State Grid each held a 1.54% stake, while hydropower generator Yangtze Power owned a 1.03% stake.

But foreign strategic investors were welcomed in the reform process. In 2005, Bank of America paid 3 billion U.S. dollars to purchase 9% stake in CCB from Central Huijin. According to the purchase agreement, Bank of America retains the option to lift its holding in the next five and a half years to 19.9%, the maximum percentage allowed now under Chinese law. Singapore's state-run investment agency Temasek Holdings (Private) Limited, through its affiliate Asia Financial Holdings Private Limited, acquired 5.1% stake at the rate of 1.19 times the book net assets of CCB on December 31, 2004 prior to the IPO of CCB in Hong Kong. The transaction condition also included that Temasek would purchase stocks of a total value of 1 billion U.S. dollars that CCB would issue at the IPO price upon the IPO of CCB.

(b) Bank of China

In 2004, the old Bank of China was restructured into the new Bank of China Share-holding Corporation. At first, there was only one share-holder, Central Huijin. But foreign strategic investors have also been introduced to share the stake.

In December 2005, a consortium led by Royal Bank of Scotland got approval to buy a 10% stake in Bank of China for 3.1 billion U.S. dollars. This consortium included Merrill Lynch and Hong Kong billionaire Li Ka-shing. Besides, the approval from the Chinese government for Temasek Holdings' purchase of a 5% stake in Bank of China is still pending. The Manila-based Asian Development Bank and Bank of Tokyo-Mitsubishi UFJ Financial Group also have expressed great interest in being the strategic investor of Bank of China.

Domestic investors also got chance in this process. Last year China Social Security Fund acquired 4% stake by an investment of 10 billion RMB. The share-holding structure will be much diversified if all the pending transactions come true.

(c) Industrial and Commercial Bank of China

In October 2005, Industrial and Commercial Bank of China became the third "Big Four" bank which was restructured into the share holding corporation. Huijin and Ministry of Finance each held a 50% stake. But the strategic investors came soon. China Social Security Fund invested 10 billion RMB in December. A consortium led by Goldman Sachs and joined by American Express Co. and Allianz AG now is waiting approval for their 10% stake purchase with 3.7 billion U.S. dollars. The Kuwait government also expressed great interest in the investment.

So at present, only Agriculture Bank of China hasn't conducted the shareholding restructuring. But this bank is actively preparing and it is expected to finish the reform within this year.

E. Public Listing in Overseas Stock Market

The ultimate aim of the shareholding restructuring of the "Big Four" is their public listing. The listing plan of each bank includes two steps, getting listing overseas first and then doing IPO in domestic stock market.

On October 27 2005, China Construction Bank Share-Holding Corporation got listed on Hong Kong Stock Exchange. It was the first "Big Four" bank listed overseas and proved a great success. According to the ambitious overseas listing schedule of the Chinese government, Bank of China will be listed in 2006; and Industrial and Commercial Bank of China and Agricultural Bank of China in 2007 or 2008. Only after stage can the “Big Four” wait for domestic IPO opportunities. So the “Big Four” still have a long way to realize their reform aims.

V. The Banking Regulatory System

A. Three Pillars of the Legal Framework

The legal framework of China’s banking regulatory system contains three pillars: Law of the People’s Republic of China on the People’s Bank of China, which was promulgated in March 1995 and amended in December 2003; Law of the People’s Republic of China on Banking Regulation and Supervision, which was promulgated in December 2003; and Law of the People’s Republic of China on Commercial Banks, which was promulgated in May 1995 and amended in December 2003. Besides, there are hundreds of regulations and bylaws issued by the State Council, People’s Bank of China, and China Banking Regulatory Commission.

B. Division of CBRC and PBC's Responsibilities

In China’s banking regulatory system, China Banking Regulatory Commission (CBRC) is the chief regulatory agency. But People’s Bank of China (PBC) still has influence on banking regulatory affairs. Generally speaking, the responsibilities of these two agencies are divided as follows:

(a) CBRC's Responsibilities

According to the newly adopted Banking Regulation and Supervision Law and the Commercial Banking law, CBRC takes the following regulatory duties:

(1) Examining and approving the establishment, dissolution, business scope and any changes in the constitution of banking financial institutions.

(2) Regulating business activities of these institutions and verifying the sources of funds and credibility of major shareholders.

(3) Supervising banking financial institutions and imposing sanctions for non-compliance.

(4) Examining financial and accounting records.

(b) PBC's Responsibilities

According to the newly revised People’s Bank of China Law and the Commercial Banking Law, PBC can influence the banking industry in the following ways:

(1) Formulating and implementing monetary policies and taking measures to avoid and minimize risks in the financial market and to stabilize RMB.

(2) Overseeing and promoting the development of the financial markets from a macro perspective.

(3) Regulating the inter-bank lending market, the inter-bank bond market, the inter-bank foreign exchange market, the gold market, and directing and deploying anti-money laundering measures.

C. Coordination between CBRC and PBC

Although CBRC and PBC take different responsibilities, there is still coordination between these two agencies to maintain a sound banking system.

Firstly, PBC has the recommendation right. It may recommend CBRC to inspect and supervise banking financial institutions to ensure their operations are in line with monetary policies.

Secondly, both of them have the penalizing power so their decisions have the absolute authority to the banking institutions. The amended Commercial Banking Law distinguishes situations where either PBC or CBRC may penalize commercial banks which have acted in violation of laws. Their powers are supplemental with each other.

Thirdly, the State Council when necessary can establish a financial supervisory and reconciliation mechanism to facilitate the information sharing between the two regulatory agencies. Although such mechanism hasn’t been officially established, the close relationship between the two agencies may smooth the cooperation.

D. Strengthened Regulation of Commercial Banks

Regulation and supervision of commercial banks is the key to a country's banking regulatory system. So the amended Commercial Banking Law has strengthened the regulation of commercial banks. These improvements include:

(1) Requiring commercial banks to establish a sound risk management and internal control system (e.g. a risk-rating system for joint-stock commercial banks was published by CBRC in February 2004);

(2) Adjusting certain requirements relating to the operation of commercial banks (e.g. change of 5% or more shareholding requires CBRC approval);

(3) Extending the time requirement on commercial banks with their disposal of immovable properties or equity interests obtained through enforcement;

(4) Clarifying the establishment procedures and organizational structure of commercial banks, the protection mechanism for depositors as well as some basic lending principles;

(5) Outlining rules on finance and accounting, takeover and termination of commercial banks;

(6) Removing the wholly state-owned banks the obligation to provide loans to projects specifically approved by the State Council.

VI. Challenges in the Banking Reform

We have to admit that for the past 20 years, China has achieved great success in the banking reform and has made stead steps towards a sound modern banking system. But we should also notice that there are still some great challenges facing Chinese reformers. If these challenges cannot be resolved properly, the whole reform can fail in the end.

A. Non Performing Loans

NPL problem is always the toughest challenge. What's even worse is that most of the NPLs in China's banking sector exist in the "Big Four". Even after the striping and the capital injection, the whole amount is still a huge number. We can figure out the seriousness of the problem from the data in the table below.

	Amount (billion RMB, till the end of September 2005)	As % of Total Lending
National State-owned Commercial Banks	1017.54	10.11
National Share-holding Commercial Banks	153.19	4.51
Local Urban Commercial Banks	102.71	9.74
Local Rural Commercial Banks	4.18	5.80
Foreign Commercial Banks	3.22	0.92
Total	1280.83	8.58

(Source: China Banking Regulatory Commission)

B. The lack of Deposit Insurance System

The second problem is the lack of a modern deposit insurance system. Chinese depositors, with one of the world's highest propensities for saving funds, take it for granted that state-owned banks are the safest places for their savings. In fact, at present the Chinese government is offering de facto insurance on deposits in the "Big Four", covering all potential losses for depositors. But the de facto insurance is not assured for other types of banks. Whether the state will bail out the failed financial institutions is within the discretion of the government. It depends on the potential social influence of the failure and many other elements. So, one cannot take it for granted that the government will certainly help banks when they are going bankruptcy.

In fact, in recent years there is increasing number of banking institution closures across the country. For example, in 1998 Hainan Development Bank was closed, leaving 14.2 billion RMB (1.72 billion U.S. dollars) unpaid debts. At the same year, Guangdong International Trust and Investment Corp. announced a 9 billion U.S. dollar bankruptcy claim, causing a panic among foreign creditors.

The biggest obstacle for adoption of a deposit insurance scheme comes from the “Big Four”. They want to continue their privilege and the corresponding competitive edge. However, it is unfair for small banking firms, which are struggling to take deposits. It may also remove incentives for the “Big Four” to further improve their risk control and corporate governance.

C. Other Challenges

Other challenges include the management of on-going internationalization and openness of the banking industry under WTO, the regulation of the emerging financial conglomerates, the reconciliation of modern commercialization with significant development needs of the country, and the attainment of a modern, international oriented and financially stable banking system to accommodate an impending major international currency and one of the world’s largest economies. All these challenges are more and more exerting their effect and cannot be ignored during the reform.

In conclusion, China has a relatively long history in its attempt to establish a modern banking system. Due to various reasons, this process was halted for many years. At the end of 1970s, China resumed its endeavor. After 1/4 century’s development, this country has already made prominent achievements. Although China has had a good start, it still expects a long march towards its aim.