China’s Financial Development

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ABSTRACT At the China Development Forum in Beijing, March 2002, I was asked to be discussant to Governor Dai Xianlong, but his paper, as in most cases, was not made available beforehand, so my own comments had to be made independently. Following that event, I can now remark on the Forum as well as reproducing my discussant paper. In this latter, I emphasize the importance of developing professional skills, greater competition and the application, through regulation, of appropriate incentives for the continued improvement of China’s financial system.

Key words: China’s Financial System; Professional Skills, Competition; Regulation; Incentive Application.

The background and rationale for this talk was that I was invited to act as a discussant to Governor Dai at the China Development Forum, March 2002. The theme of this Forum was ‘China after WTO Accession’.

This Forum – the third of its kind – is a very high level gathering of (mostly Chinese) politicians and officials, industrialists (Western and Chinese), and a few (specialists on China) economists. The forum’s sessions, held at the Diaoyutai State Guesthouse in Beijing in a huge hall with hundreds attending, were fairly formal; the relevant Minister states, for 15 minutes, what China aspires to do, and the (Western) economist acts as a discussant for 10 minutes (saying how well China has done, but how much further it has to go). The best bits were the questions (by the Chinese mainly) from the floor, often highly critical and apposite – and usually ducked by the Ministers.

I was asked to act as discussant to Governor Dai Xianglong. Opening up, and reform, of the Chinese financial system is progressing slowly. Nothing was said at all about liberalizing interest rates. Even after the transfer of a large volume of non-performing loans (NPLs) to the asset management companies, NPLs in the big 4 (State) Commercial Banks amounted to about 25% of loans on one classification basis (four categories of loans) and 30% on another (five categories). Governor Dai aimed to reduce them at 3% p.a., so they would still amount to 15% in five years’ time (hardly solvent or competitive). He hoped that only 5% of new loans would become NPLs. Insurance was being gradually opened up to foreigners.
(one city at a time) and there was some likelihood of long-term portfolio flows (in both directions) being gradually freed up. Since he arrived with his speech, I had to respond on the spot, extempore. The private comment (not by him) was that nothing serious would be done about banking until after the leadership reshuffle next year.

Other perceptions included the following.

China and the Central Government level is serious about the WTO, opening up and modernization, but simply cannot control the provinces, either fiscally or in their operational control and protectionist urge.

Secondly, the farmers (it is clearly no longer PC to talk about peasants) are having a hard time already; and rural finance, and the rural financial cooperatives have largely broken apart (Governor Dai was supposed to have sorted that out last year, but nothing had happened). The WTO is expected to hurt the farmers even more; the urban (doing nicely)/rural (doing badly) split is as serious as the West/East economic inequality, but at least the government is addressing the latter seriously.

Anyhow, what I can do now is to offer, once again, the paper that I gave then.

China Development Forum, 2002
Discussant to Governor Dai Xianglong

People. In order to achieve a successful development of China’s financial system, the first and most important requirement must be to invest in human capital, to foster the education and development of the various professional skills needed in business. These skills include banking, especially loan risk assessment skills, and the various strands of professionals whose main function is to assess values, notably accountants and real estate valuers, and lawyers.

Let me add a few further words about the dependence of finance on law and lawyers. Anyone who has borrowed money would prefer not to have to repay it. If it is made easy for a borrower not to repay, then no one will voluntarily lend and the financial system cannot run as a market system, only as a government-directed command system. In many cases, after the event of some failure that limits the ability of the borrower to repay, one’s natural sympathy is with the defaulter. The failure may have been due to bad luck rather than bad management. Many people’s jobs depend on the continuation of the enterprise, and so on. Nevertheless, the more that lenience is shown to borrowers, and bank creditors do not have the right to seize the defaulter’s assets and to liquidate them, the greater will be the reluctance of financial intermediaries to lend in the first place, except at very high interest rates and spreads that take into account the greater probability of default and of loss given default.

An essential part of the infrastructure of any market-based financial system is, therefore, a well-defined bankruptcy law, as part of a wider framework of contract law. Such a bankruptcy law must aim to protect creditors’ rights; otherwise the financial system will not work. Moreover, banks, and other financial intermediaries, must know exactly where they stand in legal terms when drawing up contracts; otherwise they cannot set relative prices efficiently. For this purpose, lawyers and the whole panoply of the civil code of law are essential. I know that China has made vast strides in the development of civil law in recent years, but there is still, I believe, some way to go before the legal infrastructure can provide a sufficient basis for a modern and efficient financial system.
Finally, it is obvious that, to function effectively, professional people in an information-driven industry – such as financial intermediation – quite simply need information. Decisions about lending can only be made appropriately if bankers have the necessary inputs to make judgements about the risks and returns in the firms to whom they advance funds. Debtors need to make this information available through high levels of disclosure – an issue not just in the area of developing financial systems, as recent problems with Enron amply illustrate.

SOEs and the State Commercial Banks

This brings me, actually quite neatly, to the problem of SOEs. A feature of SOEs is that, when and if they do fail to meet their borrowing commitments, virtually all the bargaining power in the subsequent negotiations lies in the hands of the SOE debtor, not the bank creditor. Partly as a consequence of this, SOE loans have had a very high default rate, and a worryingly high proportion of State bank loans are non-performing.

This particular nexus is, probably, the best known conundrum in this area, and I do hope that you will not feel it impertinent of me as an ignorant outsider to try out my own thoughts of how to handle one facet of the problem. I would do so by giving the banks, essentially the four State banks, the right (on a once-and-for-all basis) to put the credit risk back to the government authority sponsoring the SOE, when the risk of default is too great. Even when the risk of non-performance is less, the banks should be able to adjust the spread to match that risk. However, won’t that mean that banks would charge too much?

For example, we might, somewhat arbitrarily decide that any probability of default, greater than, say 10% on a two year loan, was not in truth a bankable proposition. With a PD of 10%, and a loss given default of, again somewhat arbitrary, 75%, you can work out what the interest spread over the risk free rate, say on government two year bonds, would be, if the expected return on the risky asset was to be the same as the risk free rate. Then, on my plan, the banks could charge a spread of the requisite amount, which I have very roughly calculated would be about 8 percentage points above the risk free rate to all borrowers, including SOEs. If the bank reckoned that the requisite spread to give it a reasonable return was even higher than this cut-off rate, then the bank would have the right to require the relevant authorities to take the credit risk onto its own books, or onto the books of an asset management company, or policy-loan bank established for that purpose. The initial money would still come from the bank, but it would go to buy a claim on the sponsoring government body, not a claim on the SOE directly. If the government body still wanted to sponsor lending that, in the eyes of the bank was so risky, then the responsibility and financial implications should lie with it, not with banks who are supposed to be acting in a commercial fashion. This solution would bring the banks closer towards the ultimate aim of pricing loans on a fully commercial basis, something that recent moves towards interest rate liberalization should ultimately achieve.

Competition

Of course, the number that might cause a gasp is the size of the spread necessary to compensate against a PD of 10% and an LGD of 75%. The natural immediate concern is that if banks were allowed to charge a spread of, say, 8% to their riskiest
borrowers, then they would charge a somewhat similar exorbitant spread to almost all their other borrowers.

To this there are two main answers. First, the cut-off spread could be lowered, but only under this scheme by requiring government bodies to take on themselves, directly, an ever greater proportion of the direct credit risk and loan assessment. They are simply not equipped to do so.

However, if a borrower thought that he was less risky than the bank’s suggested spread implied, he would have to be able to shop around and try to get a lower spread from a competing bank. To put it bluntly, this kind of scheme and a properly functioning market-based financial system with spreads related to risk only work if there is sufficient competition. Here, competition does not mean that banks end up undercutting each other to the extent that they under-price risk – but simply that any risk-adjusted excess returns are whittled away. Competition is a word that figures all too rarely in discussions of the Chinese financial system. Here in the UK, for example, the dominance of the big four banks in the market of lending to SMEs has been held to lead to anti-competitive behaviour; and the prospective shift in the number of world-scale auditors from five to four is causing many concerns.

In this context, the scale of the big four State banks, with their vast branch networks and historically specialized functions, as graphically represented in their very names, would lead me to query whether, over the major range of banking business, there was sufficient competition in Chinese banking to run a system that would need to be based on competitive pressures between banks if the system was to function well. At some point, there must be a question of whether some, or perhaps all, of the big four should be divided into two, or possibly even more, separate banks, again remembering that the objective should be to maximize competition, and not to provide comfortable, monopolistic functional or geographic niches.

An obvious requirement of this kind of approach, which is using a put option to help resolve the SOE problem, is that it depends on the bankers being able to make a reasonable prior estimate of risks, of PD and of LGD. However, risk assessment of this kind lies at the very heart of banking. If bankers cannot adequately do this yet, you cannot have a well-functioning market system of finance. This, of course, takes me back to my initial emphasis on the professional training of bankers. A good legal infrastructure, adequate information about risks and returns, sufficient competition and well-trained professionals form the centrepiece of a good, strong banking system.

**Foreign Banks**

In this context, foreign banks can play an extremely valuable role in two ways, first by increasing competitive pressures and second by helping to train more professionals in modern banking techniques. Whether the foreign banks do this by setting up branches directly, or by joint ventures with second-tier Chinese commercial banks, strikes me as a second-order issue. That said, the limitations on the required size and speed of establishment of branches of foreign banks that I have read about, notably in the *Financial Times* on Friday, 15 March, on ‘China and the WTO’, suggests that foreign banks may have more influence via joint ventures than on their own.

Nevertheless, my concern is rather that foreign banks may be too constrained to inject desirable competition into the banking system, not that they will somehow unhinge the stability of the existing structure.
Even if much progress was made towards a more efficient market system of financial intermediation in China, it will take a long time before the big four State banks can cope without a full government guarantee. Their balance sheets and profitability are not, in my view, strong enough to cope without it. That would require, I believe, a 100% guarantee, a US-style deposit insurance, which has the disadvantage of maximizing moral hazard. That in turn raises two questions. The first is how to mitigate the moral hazard in the State banks, and the second is whether the other commercial banks in China also require an equivalent guarantee, or could get by without distorting competition too much with European-style deposit insurance, which limits moral hazard by requiring a measure of coinsurance by the depositor, say involving 90% State insurance only, up to some capped limit. My guess is that the latter would be sufficient. As to ways of controlling moral hazard in the State Banks, this would have to depend on some combination of the accuracy of the external and independent audit process and the structure of the remuneration packages of the senior managers.

Regulation

I have not mentioned regulation yet. That is because I have reservations about how much outside supervisors can achieve, partly because – almost by definition – outsiders know less about the business than insiders, and also because, as bureaucrats are paid less well, they are also often – but of course not always – less able than the commercial people they are paid to regulate.

To my mind, the key requirement is to structure the system so that those in the business have an incentive to regulate themselves. What sort of controls would this require? For one thing I would insist that anyone in the financial system dealing with a set of clients would not be allowed to take a job with any such client for a period of time, say one or two years, after he or she has left his or her job in the intermediary. That would cover, for example, accountants auditing, or advising banks, and bankers with borrowing clients. Again, I would insist that anyone directly managing a subordinate is fired if the subordinate is found by someone else to be engaged in inappropriate activities, and equivalently rewarded if they find out about the subordinate themselves. Another good practice would be to require every banker to hand over their job to someone else in the bank (whether to go on holiday or otherwise) for a minimum of, say, three consecutive weeks each year. There are numerous other good practice ideas along this line.

However, what drives most people is the pursuit of money and wealth. The structure of the remuneration system is critical. I do not think that we have got this right in the West, and there is an opportunity to do much better in China. The need is to foster and to encourage long-term sustainable growth, not short-term, speculative profits. This can be done, for example, by relating bonuses to medium-term profitability averaged over several years, and to ensure that earnings and profits are accurately and independently assessed by auditors without a stake in, or conflicts of interest relating to, their client. Enron and Andersen represent a warning about what to avoid.

If you set the incentive structure so that bankers and financiers have the right incentives to police themselves, i.e. self-regulation, and that sufficient information is accurately, correctly and quickly made available to the public, i.e. the system is transparent, then the remaining regulatory structure can – and should in my view – be light and simple, perhaps limited to some rather general capital and liquidity
requirements. It sounds easy enough, but I have to say that I have considerable doubts about whether we in the West are currently doing all this in the right way, let alone the best possible way.

Conclusions

The WTO process will surely expose the Chinese economy, and within it the financial system, to some new risks. I have not, for example, touched on some of the most significant from a macroeconomic viewpoint, for example how to handle the liberalization of the capital account and what might be the resulting implications for the exchange rate.

Similarly, the process can deliver many benefits in encouraging the economy towards greater efficiency and productivity. Essentially, financial intermediation is an information-driven industry, involving the need to obtain, process and transmit information so that funds can be transferred from savers to the best, risk adjusted, projects. What that process depends on is high-class professional skills. So I will end where I began, by saying that the essential requirement is to aim constantly at improving the human capital – the professional skills of the new entrants to the industry.