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Serving the Real Economy: The Chinese Banking Sector Forging Ahead for Four Decades

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In the Chinese financial system, the banking sector has always played a leading role, thus becoming the research focus of the four decades of financial reform and opening up in China. In January 1978, the People's Bank of China (PBC) was separated from China's Ministry of Finance, signaling the first step of reform and opening up of the Chinese banking sector. For the past 40 years, by committing to the mission of reform and opening up and economic development, the Chinese banking sector has been forging ahead to serve the real economy competently and making outstanding achievements.

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Highlights in the reform and opening up of the Chinese banking sector

During the four decades since 1978, the reform and opening up of the Chinese banking sector has undergone three stages.

Establishment of the banking system in the first stage (1978–1991)

First, the framework for the Chinese banking sector was set up, with the PBC being the supervisor, the specialized banks being the mainstay, and the stock-holding banks being the supplementary. In February 1979, Agricultural Bank of China (ABC) was re-established; in March 1979, Bank of China (BOC) was re-established; in August 1979, China Construction Bank (CCB) was incorporated into the national specialized banking system; and in January 1984, Industrial and Commercial Bank of China (ICBC) was founded. Then, the initial framework for the Chinese banking sector was formed. In April 1987, Bank of Communications, after restructuring, formally opened to the public, becoming the first stock-holding bank after 1978. Later, other 12 stock-holding banks such as China CITIC Bank, Shenzhen Development Bank, Industrial Bank, China Guangfa Bank, and Huaxia Bank were subsequently established, which further expanded the banking scope.

Second, the banking sector replaced the financial department to become the main provider of funds for economic development. In the period of planned economy, state-owned industrial and commercial enterprises were mainly funded by the financial department. However, after 1980, fiscal funds could not meet the needs of economic development. Therefore, it became inevitable to promote capital expansion using bank credit. In January 1985, on a trial basis, the policy that investment in infrastructure within national budget should be mainly funded by bank loans instead of fiscal appropriation (i.e., appropriation changed to loans) was introduced and implemented nationwide. Since then, bank loans have replaced fiscal appropriation. In addition, the Chinese economy successfully avoided the poverty trap with a significant contribution from the bank credit despite a bumpy start with capital shortage.

Third, an independent operating mechanism started to materialize. In January 1986, the State Council stated in The Interim Regulations on Banking Administration that specialized banks are economic entities with an independent accounting system, signaling the independent management of banking sector, assuming sole responsibility for its profits or losses at its own risk.

Development of commercial banks in the second stage (1992–2001)

In October 1992, the convening of the 14th National Congress of the Communist Party of China (CPC) defined the goal of economic reform as establishing a new system of socialist market economy, thus clarifying the reform course where specialized banks would transition to commercial banks. There were five key points in the reform and development of the banking sector at this stage.

First, the professional operation of the banking sector was defined. On July 5, 1993, the National Financial Work Conference was held to rectify the financial order and promote financial reform. During the following two years and beyond, to curb an overheated economy, the "double business separation" policy was implemented, thus fostering the return of the banking sector to its original principal businesses. The policy includes the separation of the entities they founded from financial institutions and separation of financial services, including the businesses of securities, trusts, insurance, and other services from various banks.

Second, commercial and policy-based businesses were separated. In November 1993, the Decision on Major Issues Concerning Socialist Market Economic System approved by the Third Plenary of the 14th Central Committee of the CPC clearly stated that it is necessary to establish policy banks and separate policy-based business from commercial business. Therefore, at the beginning of 1994, under the leadership of the State

Council, the policy-based businesses of the four major specialized banks, namely, ICBC, ABC, BOC, and CCB, were spun off to form three policy banks including the China Development Bank, the Export–Import Bank of China, and the Agricultural Development Bank of China, enabling the four major banks to focus on developing commercial business.

Third, the legal system construction of the banking sector was further advanced. After 1995, a series of banking laws including the Law on the People's Bank of China, the Law on Commercial Banks, the Guarantee Law, and Law on Negotiable Instruments were successively introduced, regulating the rights and obligations of commercial banks and their scope of business, and providing legal guarantee for further reform and development of commercial banks.

Fourth, the capital funds of state-owned commercial banks were replenished. On March 1, 1997, the 30th Meeting of the Standing Committee of the Eighth National People's Congress examined and approved the proposal by the State Council regarding the Ministry of Finance's issuance of special national bonds to supplement the capital funds of state-owned commercial banks. The Ministry of Finance issued RMB270 billion special national bonds, thus allowing the capital adequacy ratio of state-owned commercial banks to reach 8% or more. This move reinforced the reform and development of state-owned commercial banks, and provided favorable conditions for mitigating the shock of the Asian financial crisis.

Fifth, bad assets were stripped off. In 1999, according to the arrangements of the State Council, RMB1.3 trillion of non-performing loans (NPLs) were stripped off from the four state-owned commercial banks (ICBC, ABC, BOC, and CCB). Simultaneously, the four asset management companies (Huarong, Cinda, Orient, and Great Wall) were established to dispose of these bad assets, laying a good base for the state-owned commercial banks to enter the 21st century free from burdens.

Deepening the market-oriented reforms in the third stage (2002–2017)

Market-oriented development involved not only the reform of commercial banks in various aspects, but also the progress made in internationalization. There were six priorities in the banking reform and opening up at this stage.

First, the reform towards corporate system and the issue of stock were accelerated. On December 30, 2003, Central Huijin Investment Co., Ltd. injected USD45 billion into the CCB and BOC, marking a decisive step in the corporate system reform of state-owned commercial banks. Since then, based on completing the introduction of strategic investors, corporate reforms, asset restructuring, etc., CCB went public through initial public offering (IPO) in Hong Kong Exchange and Clearing Limited (HKEX) in October 2005; BOC went public through IPO in HKEX in June 2006; while ICBC was listed in October 2006 simultaneously on both the HKEX and the Shanghai Stock Exchange (SSE); later in July 2010, ABC was also listed on the SSE and the HKEX. The corporate system reform and the IPO listing have fostered the transformation of the four state-owned commercial banks into state-controlled commercial banks, making their corporate governance, business orientation, and operational mechanism more market-oriented.

Second, the competitiveness of Chinese-funded commercial banks was improved. On December 11, 2001, China joined the World Trade Organization (WTO), giving the banking sector a five-year transition period. This triggered some worries that, with the influx of foreign banks, Chinese banks would be at a disadvantage. However, through institutional reforms and business transformation, Chinese banks did not go downward; on the contrary, they obtained an impressive performance. The total assets of the banking sector increased to RMB252.4 trillion at the end of 2017, 8.13 times as much as that of 2003; while the NPLs in the banking sector and their proportion fell from RMB2.44 trillion and 17.8% to RMB1.71 trillion and 1.75%, respectively. At the end of 2017, the core tier one capital ratio of the banking industry was 10.75%, with the capital adequacy ratio being 13.65%; while the net profit of the banking sector was RMB1.75 trillion, with the return on assets and capital being 0.92% and 12.56%, respectively, which were higher than those of foreign commercial banks.

Third, the supervision on banking was strengthened. On April 25, 2003, the China Banking Regulatory Commission was established to enhance the standardization of banking supervision regarding the institution, rule of law, mechanism, indicators, workflow, technology, data, and information disclosure, contributing significantly to the defense of the Chinese banking sector against the shock of financial crises and systemic financial risks.

Fourth, internationalization process was accelerated. In the context of financial globalization, Chinese banks have accelerated the development of overseas business. For example, by the end of 2016, 22 Chinese banks had established 1,353 branches (including 229 first-level branches) in 63 countries and regions, increasing the presence and competitiveness of Chinese banks in international finance.

Fifth, the business structure was improved. With the development of modern information technology, the growing demand of the real economy, and the rapid development of the financial industry, banks actively expanded their various intermediary services (bank cards, entrustment, custody, settlement, etc.). Meanwhile, they also developed all types of financial products, strengthened their capabilities on asset management and private banking customer service, and offered diverse transaction services (including foreign exchange, gold, and other financial products trading) through the Internet, mobile phones, and other vehicles, thus optimizing the service outlets. Compared to 1999, the proportion of loans in the employment of funds of the commercial banking sector decreased from 76.06% to 61.95% at the end of 2017, whereas the proportion of the non-interest income rose to 22.65%.

Sixth, the banking sector opened even wider to the outside world. At the end of 2006, with the end of the transition period after the entry into the WTO, the Chinese banking market became fully open to the outside world, and foreign banks began to enjoy the same national treatment as Chinese banks, forming the pattern of fair competition between foreign and Chinese banks. During the ten years from 2006 to 2016, the number of foreign-funded banks registered in China increased from 14 to 39, with the number of employees increasing from 16,724 to 45,613, and their total assets increasing from RMB819.4 billion to RMB3.167 trillion.

The experience of reform and opening up in Chinese banking sector

For four decades, the Chinese banking sector, in line with China's national conditions, has made unceasing explorations in practice by staying true to its original intention, and made continuous innovations in development, which bolsters the rapid development of Chinese economy and explores a way for banking development with Chinese characteristics. As a result, a banking system that is relatively complete in functions, sufficient in capabilities, and efficient in services provided was established. Such a banking system has the state-controlled commercial banks as the mainstay and the joint-stock commercial banks and policy banks as the two wings, supplemented by diversified deposit and loan financial institutions including city commercial banks, foreign banks, finance companies, rural credit cooperatives, various financial companies and rural banks, and small loan companies, providing a lot of valuable experience.

Adhering to the market-oriented reform and opening up

It was not an easy task for the Chinese banking sector to commit to this mission for 40 years. For example, there was the financial order rectification in the second half of 1993, the divestiture of non-performing assets in 1999, the international competition after China's accession to the WTO in 2001, the corporate reform in 2004, the financial innovation after 2009, and then the deleveraging after 2016. Regarding the effectiveness of the reform and opening up in the banking sector, there have been different viewpoints of supporters and opponents as well as all types of intellectual debates. This was due to the influence of the planned economic system, the mechanical application of Western theories, and the concerns over the operational risks of the banking sector (and even the possibility of a crisis). However, the Chinese banking sector has been able to consistently adhere to the general principle of "crossing the river by feeling for stones" proposed by Deng Xiaoping, during the four decades of reform and opening up. By focusing on the need to develop the real economy, it has taken the initiative to foster financial innovation and expand the scope of financial services, thus effectively minimizing financial risks and improving the quality of financial operations. In the past 40 years, the development of the Chinese banking sector has experienced twists and turns with various adjustments, but there have been no major mis-steps, and consequently, no financial panic or crises. The experience of these 40 years has had a significant role in making the Chinese banking sector market-based, internationalized, and modernized.

Developing the financial industry in line with national conditions

China's financial industry faced the choice of a development model at the beginning of the reform and opening up. On the one hand, in the 1970s, the United States began its capital market-oriented financial innovation; thus, some people argued that the banking sector would decline. On the other hand, the planned economy that relied on fiscal funds for construction triggered some concerns that the lending mechanism through bank credit would place grave debt risks on state-owned enterprises. However, considering the national conditions and practical experience, China adopted a financial development model that can give play to the basic functions of the banking sector. By utilizing bank credit, the shortage of funds in the development of the real economy was effectively alleviated. In addition, practical conditions were created for the development of the securities, insurance, trust, and leasing industries through the development of the banking sector. Looking back at the development of China's financial industry in the past 40 years, it can conclude that without the functioning of the banking sector (i.e., bank credit) in the 1980s, the real economy would have fallen into the poverty trap caused by a serious shortage of funds. Nevertheless, one might ask how could then the booming of the securities, trust, and insurance industries take place after the 1990s. In fact, the banking sector has been playing a dominant role as a "ballast" in the development of China's financial industries.

Sticking to the dominant position of state-owned banks

The construction of the Chinese banking system started in the first five years of reform and opening up. The established specialized banks, such as ICBC, ABC, BOC, and CCB, were subject to the planned economic system at that time, and broke through the constraints of the planned economic system. They boosted the operation of industrial and commercial enterprises, the construction of investment projects, and the reform and development of the real economy by utilizing the bank credit mechanism; however, those results were produced at the cost of up to trillions of NPLs. Considering a hypothetical scenario, if a private banking system instead of a state-owned specialized banking system were used, not to mention whether those private banks could have successfully raised enough working capital in the absence of a government credit support, just the huge number of NPLs alone would have landed them into a dilemma. Thus, to reduce the NPLs, the loan limit for the operation and investment of the real economy would have to be lowered, which would seriously affect the extent to which the banking sector could serve the real economy, further hampering China's economic development. Additionally, to give play to the function of bank credit, the scale and proportion of NPLs would have to increase, which the private banks could not afford. Judging from the practice during the 1980s and 1990s, putting the four major banks, namely, ICBC, ABC, BOC, and CCB under the control of a solely state-owned system was undoubtedly a beneficial choice to all parties. Entering the 21st century, with China's accession to the WTO, the improvement in China's real economy, the acceleration of the market-oriented reform, and the unfolding of economic globalization, state-owned banks were transformed into state-controlled commercial banks through restructuring. This move helped accelerating the marketization and internationalization of the banking sector, and guaranteed that the Chinese banking sector would stay manageable despite its increasing openness to the outside world. Moreover, it helped the banking sector (that is, the Chinese financial industry) mitigate the severe impacts by international capital during its operation and development.

Financial innovation with a gradual and orderly manner

Financial innovation became a mainstream phenomenon in the development of international finance after the 1970s, thus creating new financial products, operational mechanisms, processes, and trading methods. In response to this new phenomenon, the Chinese banking sector, based on the developmental needs of China's real economy, has adopted a moderate strategy using modern technologies developed by the IT industry, and introduced financial reforms and innovations in a timely manner, thus keeping risks at acceptable levels. Among these technologies, the Internet was used to provide services such as online payment, online transactions, and mobile banking. In addition, financial products were launched to reinforce the operating capabilities of asset securitization and management, integrated business, currency market operations, and so on. Moreover, intermediary services were developed to improve the business structure and the asset and revenue structure. In the past 40 years, the innovations in the Chinese banking sector in terms of institutional mechanisms, market operations, financial products, risk prevention and control, and business models have progressed smoothly. These effectively improved the sector's capabilities for serving the real economy, facilitated the financial transactions for both urban and rural residents, strengthened banks' competitiveness, prevented serious systemic financial risks, and kept financial risks at acceptable levels.

Strengthening the rule of law and financial regulation

The modern market economy is an economic system operating under the rule of law, with the banking sector being under strong external public effects. For China's financial industry, the stability of banks determines the general financial stability, while their flexibility determines the general financial flexibility. The administrative mechanisms alone cannot coordinate the relationship between stability and flexibility efficiently; thus, it is necessary to rely on the rule of law to achieve this balance. After 1995, based on previous practical experience and the established legal system in developed countries, China has successively formulated and improved a series of legal systems related to banking operations. Meanwhile, focusing on controlling financial risks, efforts have been made to strengthen the supervision of various banking financial institutions in accordance with the requirements of Basel I to Basel III and China's national conditions, ensuring a healthy and sustainable development of the Chinese banking sector.

The development of the Chinese banking sector in the new era

In October 2017, the 19th National Congress of the CPC stated that "the socialism with Chinese characteristics has entered a new era," emphasizing the need to "build an industrial system that promotes coordinated development of the real economy with technological innovation, modern finance, and human resources." Meanwhile, it also put forward that "we will deepen institutional reform in the financial sector, make it better serve the real economy, increase the proportion of direct financing, and promote the healthy development of a multilevel capital market. We will improve the framework of regulation underpinned by monetary policy and macro-prudential policy, and see that interest rates and exchange rates become more market-based. We will improve the financial regulatory system to forestall systemic financial risks." In the new era, the development of the Chinese banking sector should focus on five aspects.

Boosting the construction of a modern financial system

The banking sector plays a major role in building a modern financial system that is compatible with the real economy, technological innovation, and human resources. On the one hand, in line with the objective requirements for the development of the real economy, the banking sector should play an active role in fostering de-capacity, destocking, deleveraging, cost reduction, and weak links improvement, and alleviating the imbalance and insufficiency of financial supply, thus solving the conflict between the financial needs of the people in the context of the real economy and the severe financial undersupply. On the other hand, in the increasingly specialized financial market competition, the banking sector should actively break through the limitations of the traditional deposit and loan business, expand the scope of business, and improve its capability in serving the real economy and wealth management, thus providing adequate financial services that meet the various financial needs of various targeted customers.

Deepening the market-oriented reform of interest rate and exchange rate

Interest rates and exchange rates are the basic prices of financial products. To ensure that the market mechanism plays a decisive role in the allocation of financial resources, interest rates and exchange rates should be able to form and change according to the requirements of the market mechanisms, thus becoming the fundamental price signals that guide the allocation of financial resources. Therefore, on the one hand, it should break the sellers' monopoly of the banking sector in the deposit and loan market by vigorously developing financial products (e.g., various types of bonds and asset management products) that have substitution effects on deposits and loans. Meanwhile, it should also expand the market choices for capital suppliers and consumers to promote the reform of the banking sector's asset structure, business model, and market operation framework. On the other hand, it should deepen the reform of the foreign exchange management system and reduce the daily influence of the central bank on the foreign exchange market. Financial institutions, including commercial banks, need to strengthen their functions in handling foreign exchange transactions, and in developing foreign exchange trading objects, so that various exchange rates can fully reflect the changes in economic fundamentals and in the supply and demand of the exchange rate market.

Balancing the proportions of direct finance and indirect finance

The severe undersupply of capital funds is a serious problem hampering the development of China's real economy. This phenomenon is contradictory to the relative surplus of funds in China, with its main cause being that the huge funds generated by China's high savings have flowed into the banking system through deposits while flowing into the real economy through loans, resulting in a large number of funds that could have become capital funds converted into debt funds. This expansion of the debt funds incurred by bank credit has caused a high leverage ratio, heavy debt burdens to the real economy, and a high risk for financial operations. However, the banking sector has a huge potential for promoting the development of direct finance and increasing its proportion in financial assets. For example, through mechanisms such as investment and loan linkage, debt-to-equity swap, asset securitization, and long-term corporate bonds, entity companies can have access to more long-term funds. Moreover, through the development of asset management business, the funds can be channeled into capital investment. Further, through mechanisms such as financial and investment consulting, equity investment and other non-bank financial institutions can be guided to expand their direct finance with the information advantage.

Increasing openness to the outside world

On the one hand, it should increase the proportion of foreign capital in financial institutions including the banking sector (e.g., permitting foreign ownership), ease restrictions on the establishment of foreign-funded banks, expand the scope of the RMB business handled by foreign banks in China. In addition, it should open up the financial market in China in an orderly manner, and extend the scope of opening-up of the banking sector from the capital structure of the institution to the financial market. On the other hand, regarding the international market competition, it is necessary to accelerate the development of an international operation team for Chinese banks to enhance their competitiveness in financial resources allocation in the globalized financial market, and their ability to serve the implementation of the Belt and Road Initiative.

Preventing and controlling systemic financial risks

Since the banking sector operates on a high-debt basis, it belongs to the high-risk financial industry. However, with various instruments, technologies, processes, and mechanisms for managing and controlling financial risks, it is capable of managing financial risks. In a credit economy, bank credit will continue to create debt funds, while debt risk is the dominant source of financial risks. Therefore, the burden of financial risks control will inevitably fall upon the entire operation process of various commercial banks. On the one hand, it should effectively implement the Basel Accords and strengthen the internal control system to prevent liquidity, market, and operational risks. On the other hand, in the process of business transformation, it should reduce the operational risk by strengthening asset restructuring and liability structure management, and expand the asset management business by strengthening the risk management of asset portfolios. In addition, the operation of the banking sector is highly procyclical. Thus, it needs to build a risk prevention system to effectively prevent the risks brought about by economic and financial cycles and prepare relevant emergency plans.

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