Challenges of the State Banks of China

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July 17, 2013

Co-author Tal Levy. Research support by National Science Foundation grant No. 0451945.

Research problem

- Large state banks of China dominate China's financial sector
  - Bank of China
  - China Construction Bank
  - Industrial and Commercial Bank of China
- Reform—major policy effort of China's government
  - financial weaknesses exert drag on economy
- Reform addresses wide range of issues
  - overall financial system
  - corporate governance
  - regulation, ownership
  - non-performing loans
  - bank capitalization

Research problem—continued

- Reform efforts fail to deal with two continuing problems which banks face
  - poor access to expert knowledge
  - non-performing loans
- Recurring problems rooted in network governance of banks
- Network governance
  - structure of network relations among individuals and banks
  - flows of resources over networks
  - power exerted through networks

Research problem—<u>continued</u>

- Chinese government must transform network governance to make banks globally competitive

  - **Constitutes one of Beijing's greatest challenges**

Bank reform—quick review

- China's financial markets liberalized during 1990s
- Banks gained authority to write off loans
- 1994—SBOCs (state banks of China) released from policy lending—policy banks established

End of 1990s

- Government injected billions of dollars of capital into big banks
  - created four asset management companies to take over non-performing loans (NPLs)

Bank reform—continued

- Recapitalization of SBOCs continued after 2000
  - scale may have approached 20%+ of China's gross domestic product (2004 benchmark)
- SBOCs float initial public offerings (IPOs) on Hong Kong and Shanghai Exchanges
  - 2002—Bank of China (Hong Kong)
  - 2005—China Construction Bank
  - 2006—Bank of China (Beijing, the parent company)
  - 2006—Industrial and Commercial Bank of China
- Minority stakes held by
  - foreign banks and other institutions outside China
  - individual investors

Bank reform—continued

2003

- China Banking Regulatory Commission (CBRC) formed
- Central Huijin Investment (Huijin) created

supervised by

- Ministry of Finance
- People's Bank of China (PBOC)
- State Administration of Foreign Exchange

  - Huijin is government's investment vehicle in publicly listed SBOCs

2007

- Government established China Investment Corporation (CIC)

  - capital of US$200 billion from foreign exchange reserves
  - purchased Huijin Investment which operates as unit of CIC

Network governance as a theoretical lens

- Corporate governance focuses inside firms
  - with attention to some external relations
    - stockholders, auditors, and the like
- <u>In contrast</u>: network governance emerges because:
  - complex, contentious decisions about funding SOEs
  - decision makers (financiers, government officials, Communist Party cadres)
    - must customize capital exchanges for government and private enterprises

Network governance as a theoretical lens—continued

- Networks required to facilitate flows of information
- Trust built through network relations among financiers and their institutions
  - essential when trying to coordinate financial deals
- Network governance diverges:
  - from market governance based on contracts, prices, and independent decision makers
  - from hierarchal governance system based on administrative fiat and formal bureaucratic procedures

Network governance principles

- Actors occupy different network positions
  - thus benefits and constraints may diverge
- Financier occupying a central position
  - possesses greater access to expertise and resources than less-central financiers
  - provides sponsorship for less-central financiers' careers
- Structures of networks impact flows of information, knowledge, and resources

Network governance principles—continued

Weak-tied networks

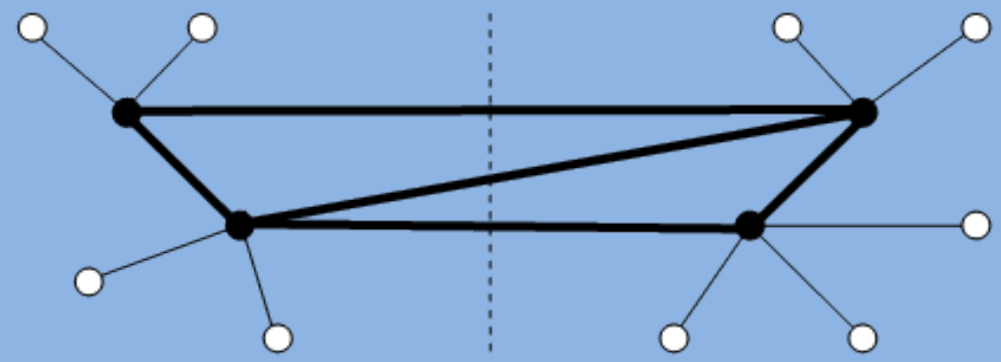
- Financiers spend little time with each other and share few resources
- Infrequent links can transmit information
- Extensive weak-tied network provides widespread contacts
- Transmits large amounts of novel information
- Financiers who serve as bridges to other networks of financiers possess even more contacts

Network governance principles—continued

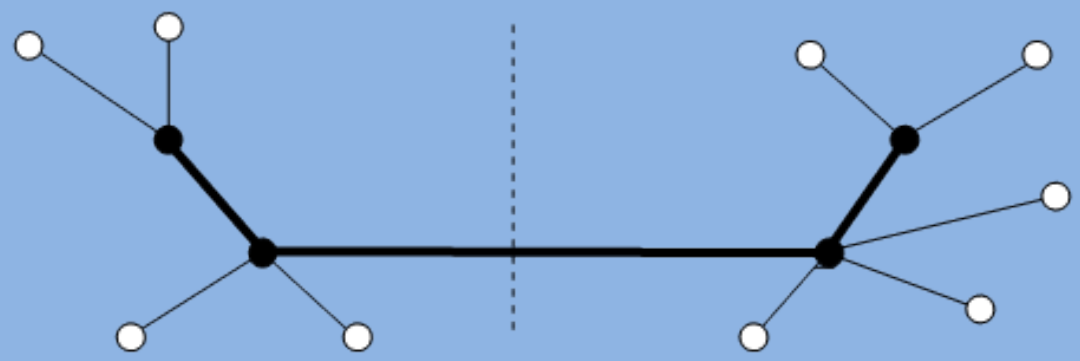
Structural holes

- Gaps in networks that provide opportunities for financiers who forge bridges to capture benefits and exert control
- If financier bridges to each of two other financiers who are not linked—thus structural hole exists between them
  - then individual building bridge gains access to nonredundant information
- Financiers become *tertius gaudens* who control flows of information or resources between other financiers
  - financier can exploit control to exert structural constraint over others' behavior
  - power to influence them even if they resist

Social networks with many structural holes



Inefficient



Efficient

Leading firm
Other firm
Strong tie
Weak tie
Social network boundary

Network governance principles—continued

Structural cohesion

- Group of financiers with large numbers of network ties among its members possess cohesion
  - generates positive benefits
    - financiers willing to devote time and effort to exchange knowledge and provide assistance to each other
  - promotes members' social identity
  - creates and sustains normative framework for financiers to determine courses of action

Network governance principles—continued

- Structural equivalence
  - members of cohesive group possess same contacts outside the group
- Strong ties based on repeated cooperation serve as vehicles to transfer knowledge and assistance
- Multiplexity—relations have multiple bases (work, school ties, friends)—enhances social cohesion
- Sanctions—cohesive groups can enforce sanctions on members who violate group norms or appear untrustworthy

Assessing recurring challenges of SBOCs

Recurring challenges

- Difficulty accessing expert knowledge
- Problem of non-performing loans

Focus on banks restructured first in order to have IPOs

- China Construction Bank (CCB)
- Bank of China, Beijing (BOC)
- Industrial and Commercial Bank of China (ICBC)

China Construction Bank

Bank of China

Industrial and Commercial Bank of China

Difficulty accessing expert knowledge

Table 1. Boards of Directors and Percent Chinese Government Ownership of China Construction Bank (CCB), Bank of China (BOC), and Industrial and Commercial Bank of China (ICBC) in 2008

Directors	CCB	BOC	ICBC
Government selected	7	7	7
Independent-outsiders	6	3	4
External shareholders	1	2	1
Senior management	2	3	3
Total	16	15	15
% Chinese gov't ownership*	68%	71%	71%

* Shares held by Huijin and the Ministry of Finance.
Sources: Annual Reports of China Construction Bank, Bank of China, and Industrial and Commercial Bank of China, for 2008.

Government-Selected Board Members

- Bureaucratic elite, highly educated in economics, finance, law
  - reflects transformation of upper levels of Communist Party in post-Mao years

Chairmen and Executive Directors of the Boards

- Guo Shuqing (CCB)
  - doctorate of law degree, visiting fellow, Univ. of Oxford
  - previously, Chairman of Huijin Investment, Deputy Governor of People's Bank of China (PBOC), deputy provincial governor, senior executive in various government economic and planning agencies

Chairmen and Executive Directors of the Boards—continued

- Xiao Gang (BOC)
  - masters in international economic law
  - long, distinguished career at PBOC, briefly President of BOC

Chairmen and Executive Directors of the Boards—continued

- Jiang Jianqing (ICBC)
  - doctorate in management
  - most of career at ICBC, rising to presidency immediately prior to present position

Government control through non-executive directors

- Chairman and six of non-executive directors in each bank
  - cohesive, structurally equivalent group
- Chairmen paid by banks
  - appointments by controlling shareholders, Huijin Investment for CCB and BOC and Huijin and Ministry of Finance for ICBC
- CCB and BOC—Huijin employs six non-executive directors in each bank
  - form cohesive networks within each bank
- ICBC—three non-executive directors employed by Huijin and three by Ministry of Finance
  - somewhat less cohesive group

Government control through non-executive directors—continued

- Collectively—fifteen of non-executive directors of three banks
  - highly cohesive group based on employment by Huijin
  - promotes identity of banks as SBOCs
  - reinforces group norms about how banks should behave
  - network exhibits closure based on common employer
  - possess unusual capacity to exert structural constraint on each other regarding decision making of boards of directors
    - and enforce sanctions on deviant behavior

China Investment Corporation (CIC) controls Huijin Investment

Eighteen non-executive directors network ties outside current board positions and employment

- Remarkably high level of structural equivalence
- Network ties reach many of same organizations
  - bring redundant information and expert knowledge to banks' boards
- Prior to current positions three-quarters of eighteen directors spent part or most of careers in four organizations
  - Ministry of Finance (6 directors)
  - State Administration of Foreign Exchange (3)
  - People's Bank of China (2)
  - China Securities Regulatory Commission (2)
- Of remainder, two worked in various financial, tax, and economic policy organizations, mostly in national government,
  - and one held various bank supervisory positions

Eighteen non-executive directors network ties—continued

- Each director—diverse weak ties to individuals within their organizations
  - and to people in other agencies with whom they occasionally worked on projects
- But, expert knowledge communicated through ties
  - most likely possesses little heterogeneity and limited novelness
    - most contacts relate to financial, tax, and economic policy issues dealt with by government bureaucracies

Eighteen non-executive directors network ties—continued

- Embeddedness in networks of various agencies and ministries
  - builds rich expertise in
    - bureaucratic affairs
    - managing large organizations
    - understanding policies and strategies of financial ministries and agencies
- **But,** not embedded in networks of sophisticated domestic and international financiers in private sector
  - cannot impart expert knowledge regarding
    - strategies for competing with foreign banks in corporate lending
    - selecting business sectors to expand or contract
    - building corporate finance team

Independent outsiders

- Access non-redundant, heterogeneous knowledge about
  - global political economy
  - finance
  - accounting
  - stock exchanges
  - elite academic understandings regarding economics, finance, and banking
- Ties are not structurally equivalent
  - provide novel information
- **<u>But</u>**, only one outsider in CCB and two in ICBC are active international financiers
  - limited network ties forged to international financial community

Four external shareholder representatives

CCB board

- Bank of America chose its Vice-Chairman of Corporate Development
  - experiences in corporate planning and senior management of large domestic U. S. bank
  - no direct international experience in corporate and investment banking
  - contributes to discussions of domestic retail and corporate banking

Four external shareholder representatives—continued

BOC board

- Singapore government's Temasek Holdings
  - former executive of a Singapore private bank
  - direct international experience, not active for decade
- Former senior executive of UBS
  - worked in international credit risk assessment
  - little experience with corporate and investment banking

Four external shareholder representatives—continued

ICBC board

- Goldman Sachs representative brings immediate international financial experience
  - only director representing external shareholders who actively participates in international financial deals
  - chairs Investment Banking Division of Goldman Sachs

Christopher Cole, Chairman of Investment Banking Division, Goldman Sachs

Conclusion—external shareholders

- Bring global financial perspectives to banks' boards
  - **<u>But</u>**, except for Goldman Sachs, do not provide senior management
    - with bridges to sophisticated networks of active international financiers

Conclusion—external shareholders—continued

- Since 2008, ownership stakes of foreign banks have altered
  - Bank of America reduced its CCB stake to 11% to replenish capital lost during economic crisis
    - continued expert knowledge sharing functions at operating level, not strategic level of board
    - Bank of America's financial problems and declining ownership point to
      - waning capacity to impart expert knowledge to CCB board and senior management

Conclusion—external shareholders—<u>continued</u>

- Singapore government's Temasek Holdings purchased CCB shares of BA, raising stake to 7%
  - **<u>but</u>**, limited capacity to impart expert knowledge to CCB about running international bank
  - Temasek is investment fund, none of its eleven board members have ever served as international financier
- UBS sold all stock in BOC 2008-09 to replenish capital lost during economic crisis

Conclusion—external shareholders—continued

- Goldman Sachs reduced stake in ICBC by 20% in June 2009 to rebuild its capital
  - decrease, and prospect for more cuts in stake, point to diminished impact of Goldman
- Foreign ownership produced mixed results for SBOCs
  - disagreements over partner relationships and differences in corporate cultures and operations undermined results

Senior management

- Each bank places its top three executives on their boards
- Thirty senior managers are an educated elite
  - twelve hold doctorates, fourteen have masters
  - six earned advanced degrees from foreign universities
- Typical career path included senior positions
  - head (or deputy) of key departments at headquarters
  - many were presidents or vice-presidents at branches of state banks in important cities or provinces

Senior management—<u>continued</u>

- These talented administrators possess expertise about economics, finance, strategy, policy
- **<u>Nevertheless</u>**, operate in network governance framework isolating them from expert knowledge embedded in networks
  - leading private domestic banks in China
  - global financial firms

Senior management—continued

Managers are cohesive group with high closure

CCB

- President previously worked in Bank of Communications
- Vice President on Board of Directors, along with eight of other top-ten executives
  - spent entire careers at CCB

ICBC

- All three executives on board spent most or all of careers at ICBC
  - four of five remaining financiers spent entire careers at bank

Senior management—continued

BOC

- Executives somewhat less cohesive
- Three on board previously worked at other SBOCs (one at CCB, two at ICBC)
  - three of six remaining spent entire careers at BOC

Senior managers—cohesive with high closure

- Executives had overlapping careers administrating major departments at headquarters
- Prominent branch presidents and vice presidents knew each other through meetings of senior managers
- Many climbed career ladder together
- Extensive bonds, exert structural constraint on each other

Senior managers—cohesive with high closure—continued

- Extreme embeddedness hinders capacity to seek outside advice to enhance profitability of banks
- Overembeddedness creates macro culture, values consensus

Large amounts of recurring bad loans

- Scale of nonperforming loan (NPL) problems at SBOCs obscure
- During late 1990s guesses overall ranged above 25%
- Subsequently, NPLs fell dramatically
  - China's government injected capital into banks and shifted bad loans to asset management companies
- Legitimacy of low share of NPLs since 2002 relative to 1990s as accurate measure of bad loans remains disputed

Problems with NPLs rooted in structure and incentives of banking system

Reasons:

- Poor risk assessment and weak credit analysis
- SBOCs remain under pressure to support state-owned enterprises (SOEs)
  - prop up local employment
  - spur local economic growth
  - prevent social unrest
- Central government uses SBOCs to funnel cheap credit into economy to spur growth
  - inevitable side effects are large amounts of future NPLs

Problems with NPLs—continued

Poor risk assessment and weak credit analysis

- Decisions on loans made on basis of network governance relations among key actors
  - rather than credit ratings models
- Senior bankers, local government officials, and heads of SOEs—most are members of Communist Party
  - exert structural constraint on loan officers and credit analysts to remove opposition to offering loans

Problems with NPLs—continued

Poor risk assessment and weak credit analysis—continued

- State Council wields direct constraint on SBOCs through orders to reclassify loans out of NPL category
- SBOCs possess limited structural autonomy to deal with non-performing loans
- As economic crisis intensified in late 2008
  - SBOCs rolled over loans and lengthened loan maturities, pushing NPLs into the future

Problems with NPLs—continued

Support of SOEs

- Restructuring vast SOE sector loomed as dilemma since start of economic reforms in 1980s
- Although SOEs improved productivity since late-1990s, they remain inefficient, often unprofitable, over-indebted, and over-staffed
- Lending bias to SOEs, limited commercial orientation of banks, and poor pricing of credit risk continued after 2000
- Raises puzzle: why would state banks make lending decisions which inevitably generate rising levels of NPLs?

Problems with NPLs—continued

Support of SOEs—continued

- Beijing leadership and powerful provincial government officials charge
  - top members of local government (all Communist Party members)
  - other Party cadres in various positions
    - with ensuring local economy grows rapidly
- Career mobility depends on success in this effort
- Consequently, they support SOEs, favored enterprises, and development projects to strengthen economy

Problems with NPLs—continued

Support of SOEs—continued

- Senior local bank officials (who also are Party members) control access to funds for economy
- Their appointment, just as with the SOE heads and chief local government officials,
  - are handled by personnel committee of Party's Central Organization Department
- Discipline Inspection Committee of Party investigates instances of corruption
  - and makes decisions about removal and discipline

Problems with NPLs—continued

Support of SOEs—continued

- These conditions frame structural embeddedness of bank in local political-economy
- Senior bankers approve major lending decisions
  - directly involved in negotiating loans with SOEs, local enterprises, and real estate developers
- Social relations bind financiers, executives of SOEs, local government leaders, other senior Communist Party cadres
- Each has vested interest in considering needs of others to assure success of local economy

Problems with NPLs—continued

Support of SOEs—continued

- Frequent contact over financial issues and Party affairs
  - generates reciprocal exchanges of support, reinforcing their cohesion
- They structurally constrain each other because their senior Party positions grant authority to call on support of Discipline Inspection Committee
  - thus enforcing sanctions on deviant behavior

Problems with NPLs—continued

Support of SOEs—continued

- This interpretation of bank's structural embeddedness in local political economy does not explain why it gives loans with high probability of failure
  - failed loans make senior bank officials appear ineffective
  - local Party cadres who exert influence to award these loans also seen as inept

Problems with NPLs—continued

Support of SOEs—continued

- Bank makes loans to SOEs, local government-linked enterprises, and real estate developers because bank cannot enforce “hard budget constraint”
  - such budget constraint means borrower cannot receive support from other organizations to cover losses
  - ceases operating or exits business when deficit becomes too large

Problems with NPLs—continued

Support of SOEs—continued

- SBOC only can enforce "soft budget constraint" on borrower, especially SOE
- When bank grants loan
  - may orally state consequences of breaking loan covenants
  - include requirements in loan documents
  - imply it will not implement any bailouts of loans should they go bad

Problems with NPLs—continued

Support of SOEs—continued

- Once failure of loan becomes evident, covenants attached to loan are not enforced
- SBOC provides bailout to borrower either through lending more money or writing off part of or all of the loan
- SBOC willing to do this because it expects the central government to bailout bank when its NPLs become too large

Problems with NPLs—continued

Central government economic stimuli

- Beijing government uses SBOCs as conduits of cheap credit to stimulate economy
- Reached substantial scale with onset of global economic crisis at end of 2008
  - government created stimulus package of 4 trillion yuan (almost US$600 billion)

Problems with NPLs—continued

Central government economic stimuli—continued

- China's State Council urged banks to expand lending
  - they responded with new lending programs
  - by middle of 2009 state banks boosted loans by 7 trillion yuan (about US$1 trillion)
- SBOCs funneled much of loans to SOEs
  - assumed central government would back loans if they failed

Problems with NPLs—continued

Central government economic stimuli—continued

- Pressure on SBOCs to support economic stimulus efforts of Beijing government
  - exacerbates recurring bad loan dilemma which banks face
- Rush to renew existing loans and grant huge amounts of new loans
  - coupled with pressure from the government to lower standards
  - exposes problems of network governance which banks confront

Problems with NPLs—<u>continued</u>

Central government economic stimuli—<u>continued</u>

- Cannot readily conduct objective risk and credit analysis
  - bank employees must consider views of senior bank officials, heads of SOEs, and local officials
- SBOCs know government will rescue them if NPLs become too large

Conclusions

- China's government has extensively reformed its big state banks
  - China Construction Bank, Bank of China, and Industrial and Commercial Bank of China
- Reforms fail to significantly alter network governance of the SBOCs
- Result is banks plagued by two recurring problems
  - poor access to expert knowledge
  - non-performing loans
- Network governance of SBOCs will continue to generate problems