

CHINA'S BANKING TRANSFORMATION

THE UNTOLD STORY

JAMES STENT

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CHINA'S BANKING TRANSFORMATION



Preface

IN THE COURSE of my three years of service as an independent director on the board of China Minsheng Bank, and ten years at China Everbright Bank—in total thirteen years spanning 2003 through 2016—I watched China's banks transform from damaged relics of the planned economy into modern commercial banks. Although much further development is needed in the Chinese broader financial system, the change in the quality of Chinese banks that I watched over those thirteen years can only be described as a “night and day” transformation.

Yet most accounts in the media, in financial analysis, and even in much academic work give little recognition to what has been achieved in the Chinese banking sector over recent years. Indeed, much of the literature, popular and specialized, is highly skeptical of the Chinese banking sector. The widespread acceptance of this negative view has led to writing this book in order to provide a different, and more balanced, perspective than is found in the consensus negative view.

My involvement with Chinese banking began on a summer morning in 2003, when I walked into a reception room of the head office of the China Minsheng Bank for a meeting with the bank's founder and chairman, Jing Shuping. Since its founding in 1996, Minsheng had maintained its head office in a venerable building on Zhengyi Road, just east of Tiananmen Square in the former Legation Quarter. Unlike much of Beijing, which has been extensively rebuilt, the former Legation Quarter around Zhengyi Road, including the Minsheng Bank head office, had remained architecturally intact. The well-preserved building was constructed in 1910 as the Beijing branch of the Yokohama Specie Bank. Architecturally it

is an Asian transplant of late nineteenth-century brick and stone Dutch architecture in vogue among Japanese at that time.¹

China's ongoing reforms had recently mandated modern corporate governance practice in listed companies such as Minsheng Bank. Under the new requirements, Minsheng's board should include four independent directors. Jing Shuping had selected three Chinese professionals to be independent directors, but he also wanted to identify a foreigner with both banking experience and Chinese language ability to serve as the fourth independent director. Consultation with, the International Finance Corporation, a World Bank affiliate, which was advising Minsheng at that time, led to the suggestion that I might be a candidate.

An inner door of the ornate century-old reception room opened, through which walked Chairman Jing, dapper in well-tailored suit and tie, but walking slowly at the age of 83. Slight of frame and frail in appearance, he nonetheless exuded warmth, energy, charm, and a piercing intelligence. Born into a Shanghai capitalist family, he had assisted his father prior to 1949 in running the family's manufacturing business, and was one of the capitalists who had chosen to stay in China after the civil war ended. The Cultural Revolution years were not kind to him, but he had endured and gone on to become one of the most respected and senior non-communist party figures in China during the '80s and '90s, serving as vice chairman of the People's Consultative Congress and as chairman of the All-China Federation of Industry and Commerce. Through these positions, he developed a broad network of contacts in the emerging Chinese entrepreneurial world. Jing and several other leading entrepreneurs in the All-China Federation proposed to the then-Deputy Prime Minister Zhu Rongji that a new commercial bank be established, to be owned entirely by private businessmen. Zhu backed the idea, and the Minsheng Bank was established in 1996, with Jing as chairman of the board, and shareholders who ranked among the wealthiest of China's new capitalists.

Our conversation ranged for half an hour across a variety of subjects, touching on culture, travel, and of course banking. Chairman Jing indicated that I would be nominated as an independent director at the forthcoming annual general meeting of the bank's shareholders, and thus began the Chinese portion of my banking career.

The circuitous path that had led me to that interview with Chairman Jing had begun in 1973, when I joined Citibank of New York as a junior officer in its Asian Division. After brief training in head office, I spent four years in Citibank's Philippine and Hong Kong branches. In Hong Kong I transferred to Crocker National Bank of San Francisco, which assigned me first to Hong Kong, and then to Thailand, where I lived and worked from 1979 through 2002, and again from 2007 to the present time.

Those eight years during the 1970s working in American banks comprised the first stage of my banking career. It was in those two banks that I absorbed the conservative

¹ Li Luke and Hu Jiezhong, eds., *Beijing Gujianzhu Ditu* (Beijing: Tsinghua University Press, 2009), 204–205.

tenets of an earlier era of banking practice. Those were the last years of the highly regulated era of banking that had been the norm in America since the New Deal reforms of the 1930s. Banking was a stodgy career choice. Yet the American banking system was then relatively stable and the postwar economy was going through a golden era of prosperity.

In those days at Citibank new recruits underwent intensive training in the basics of the profession. We rotated through every department in our training. From the tellers we learned out how to pay out and receive cash and how to balance ledgers at the end of the day, from the foreign department clerks we learned the intricacies of negotiating letters of credit, and so forth. The emphasis was on controlling risk, and on doing things properly. The bank's thick accounting and procedure manual was our bible. I was imbued with the craft of banking, with the precepts of risk control, and with a strong sense of protecting the interests of the depositors and of the bank. Most of what I know and believe to be important about banking, I learned in those early years of my career.

That was the style of banking that had stood America in good stead during the first three prosperous postwar decades. But change was afoot, the Reagan revolution started in 1981, and the rational markets theories of economics gained broad support, providing the intellectual rationale for sweeping deregulation over the next twenty years. The culture and style of Citibank of today is far different from the Citibank for which I had worked.

At just that time, when the banking world was changing, I left Crocker and American banking to join a small, privately owned Thai bank, the Bank of Asia. I was to spend eighteen years with Bank of Asia, during most of which time I was its only foreign employee. The youthful CEO, Yos Euarchukiati, scion of the Sino-Thai family that was the dominant shareholder of the bank, realized that the days of old-fashioned overseas Chinese style banking would soon be over in Thailand. The bank would need to professionalize to meet the challenges of the rapidly developing economy of Thailand. First under Yos, and then under his successor Chulakorn Singhakowin, I worked as part of a team of Thai professionals to change Bank of Asia from a traditional into a modern bank.

My stints with the two American banks had provided me with the fundamentals of the craft of banking as it had been practiced in America prior to the deregulation era. The succeeding years with the Thai bank gave me an opportunity to work inside an Asian financial institution in a developing country, tasked to introduce international best practice and bring about organizational change in a local bank. One of the lessons I learned at Bank of Asia was that change must be sequenced, that "big bangs" within an Asian organization were a likely road to failure. Another lesson was the importance of change management—ensuring that all stakeholders in the organization are fully supportive of the change agenda, and that their interests have been given due respect. If all stakeholders were not "with the program," those left out could all too easily subvert the change agenda. I learned to be patient with a pace of change that might seem unnecessarily slow, but which in the end would prove a reliable path to reaching our objectives. Those lessons in organizational change at the micro level would provide me with insights into understanding how the reform program worked in China at a national level.

The years of modernizing and professionalizing the bank paid off. The Bank of Asia survived the systemic meltdown of the Thai economy during the Asian financial crisis of 1997—the bank’s sound management attracting a large capital infusion from ABN AMRO Bank of the Netherlands. From the crisis itself, and from the painful but quick recovery over the next five years, I learned not only about sustainable banking, but also about macroeconomic policy pitfalls in developing countries—real estate and stock exchange bubbles, ill-advised monetary and foreign exchange policies, and the hubris that accompanies rapid economic growth, leaving a country vulnerable to unanticipated shocks.

In 2002 I retired from Bank of Asia, moved to Beijing, and worked on several projects there, including service on the board of Minsheng Bank. I developed the highest respect for Chairman Jing Shuping. Despite his advanced years, and despite having been cut off from the West for thirty years, Jing was keenly aware of international economic and financial currents, was extraordinarily progressive, and immediately grasped new concepts presented to him. The strong growth of the bank in those early years owed much to his leadership and vision.

Shortly after completion of my three-year term as an independent director of Minsheng Bank, I accepted an offer to be an independent director of China Everbright Bank. Both Minsheng and Everbright are listed on the Shanghai Securities Exchange, but Minsheng shares are almost entirely in the hands of private shareholders, whereas, following a recapitalization mandated by the State Council in 2007, the state, through several vehicles, is the majority shareholder of Everbright Bank.

I served two terms (the maximum allowed by governance regulations) of three years each as an independent director of Everbright Bank, starting in 2006 and finishing in 2012. During most of that period, I chaired the Board’s Audit Committee, and was also a member of the Risk, Strategy, Nominations, and Compensation Committees. The full board met at least five or six times each year. Committee meetings were held immediately prior to the full board meetings, altogether lasting two or three days. After the completion of my two terms as an independent director, I was elected one of two outside members of the bank’s board of supervisors, where I served until the completion of my term in 2016.

Widespread skepticism about Chinese bank quality prevails among both analysts and the general public. I acknowledge that my view that there has been a “night-and-day” transformation of Chinese banks since the 1990s is contrary to the impression conveyed by most foreign media accounts—which generally describe Chinese banks as fragile and inefficient, perhaps headed for crisis. This view has now become widely accepted outside of China. I find these views ill-informed, misleading, and perhaps imbued with a bias, sometimes conscious but generally unconscious, against a system that is avowedly “socialist” at a time when adherents of neoliberalism and market capitalism are intolerant of alternative models.

I felt the need for a corrective to the prevailing gloomy and censorious view, so in 2012 I began the research and writing of this book on the banking transformation to which I had been privileged to be a front-line witness. In the wake of the financial

collapse of 2008, the published academic analyses and popular accounts of the failures of banks in America and the United Kingdom have been of high quality and insightful. Collected together, they would fill several bookshelves. Curiously, although journalists and investment analysts have written frequently on day-to-day developments and problems in Chinese banking, only a handful of books, think tank specialist surveys, consultant and rating agency publications, chapters in larger overall studies on China's economy, and academic articles have dealt with the development and prospects of Chinese banks, and most of these are not easily accessible to the non-specialist. I hope this book fills that gap.

Unlike more academic treatments, or journalistic accounts, I have not written from the vantage point of an outside observer or researcher. This book is an account of banking told by a professional banker, with the benefit of access within banks and of input from many Chinese and foreign banking practitioners. This book is not, however, intended to be an authoritative or scholarly history of the development of Chinese banking over recent decades. Such a book is much needed, and hopefully will be written.

China is the second largest economy in the world. A banking crisis in China would have enormous impact on China's economy, and that would rapidly turn into a global economic and financial crisis. Moreover, as China moves beyond Deng Xiaoping's foreign policy of "hiding its light" and asserts itself internationally, how China manages the stability of its banking system, how its banks expand overseas, how its financial system becomes more open and integrated with global systems, and what China thinks about global financial architecture take on global importance. It is therefore imperative that anyone concerned with China's political economy should have a deeper understanding of China's banking system than perusal of the media provides.

Development of the Chinese banking sector, lying at the heart of the nation's economy, can serve as a case study for understanding what happens in other sectors of China's economy, even in non-economic areas. It is my hope not only that readers will take away from this book a clearer picture of Chinese banks, but also that an understanding of the banking sector will provide a prism through which to understand how China as a whole works.

The introductory chapter, "China's Hybrid Banks" sets forth the overall argument of the book that China's banks are hybrid creatures, operating in most ways like modern Western banks, but designed to serve the real economy under the guidance of the Communist Party in a market socialist political economy. The hybrid character of Chinese banks combines extensive borrowing of Western banking practice and concepts of corporate governance with traditional Chinese beliefs in how society and the political economy should be ordered. The result is a banking system that has effectively contributed to national economic growth, but which has attracted a plethora of foreign criticism because it does not adhere to conventional Anglo-American concepts of how modern banking systems should run.

China's banking transformation story would not be comprehensible to non-Chinese readers without explanation of how China's culture and historical development have

influenced contemporary Chinese banking, and how Chinese banks fit into the broader political economy. Too often misunderstanding of Chinese banking practice and policies stems from viewing the Chinese system through the lens of a non-Chinese, and particularly Anglo-American, ideological framework that does not take sufficient account of the very different culture and political economy in which Chinese banking is embedded. Chapters 2, “Culture Matters,” and 3, “Leninism and Pragmatism: China’s Communist Party,” provide essential background on Chinese culture and political economy to make the main narrative of the banking transformation comprehensible in the broader context of how China works today. They explain how the persistence in contemporary China of Confucian views of how society should be ordered provide the rationale for strong party-state control of the banks. They also explain the “why” and “how” of the Party’s role in Chinese banks, particularly through its powerful Organization Department, which controls senior appointments in the banks.

Chapter 4, “Transformation: From Bursars to Bankers,” provides a chronological narrative of the development of Chinese banking over the years since Opening and Reform commenced in 1976. It relates the principal phases of development, the search for a model of banking that would suit China’s needs, and the financial turmoil of the 1990s, which led to recognition of the priority that should be given to development of a healthy banking system and thus to Zhu Rongji’s dramatic reform program to transform banking into a modern system.

Having related how the transformation took place, Chapters 5 and 6 describe Chinese banking as it is today. Chapter 5, “Bankers,” discusses how Chinese banks are managed and governed, the quality of human resources, and the role of the Communist Party in banks. Chapter 6, “Systems,” is a more technical chapter discussing the credit quality and risk management, internal controls and auditing, IT capabilities, strategies and nature of competition of Chinese banks. These two chapters are heavily based on my own understanding of how Chinese banks work arising out of my service on the boards of two banks, corroborated by a large number of Chinese and foreigners with sound knowledge of Chinese banking from various different perspectives. What I have written in these chapters has been confirmed by other foreigners and Chinese with firsthand knowledge of Chinese banks.

Chapter 7, “Power of the State,” describes how the state exercises control over the banking system indirectly through its coordination of the resources of the “national balance sheet” and directly through ownership of banks and through the financial regulatory authorities.

The achievements of the government in expanding financial access broadly through society and the economy are contrasted with the underdevelopment of “direct finance”—the bond and equity markets—in Chapter 8, “Financial Structure, Deep but Narrow.” Chapter 9, “Coming In and Going Out,” describes the restricted but nonetheless important role that foreign banks play in the Chinese system, and the challenges that Chinese banks are facing as they expand overseas.

Is China's present banking system, as described in this book, entirely a creature of the present communist regime, or has it arisen out of Chinese ways of organizing the political economy that predate communist control of the country? Is the way in which banks operate within the broader political economy unique to China, or does the Chinese experience bear similarities with the experience of other countries? These questions are explored in Chapter 10, "China's Banks, *Sui Generis*?" through a retrospective of Chinese banking from late imperial times up to the end of the Republican era in 1949, and through looking at two of the other Asian developmental states, Japan and South Korea.

The arguments of those who believe China's banking system remains fragile and heading for crisis are examined in Chapter 11, "Collapsing or Adapting?," followed by a sketch of the principal challenges facing Chinese banks—particularly asset quality issues and the threat from nonbank digitally based competition. The likely course of future banking reform is the subject of Chapter 12, "Reform Directions."

The concluding chapter discusses the challenges China's banks face as the economy transitions into a lower-growth, less investment- and export-dependent economy—the New Normal. The success of the banking transformation in terms of providing the country with a banking system that provides broad financial access, allocates capital efficiently, and is a sustainable and stable system is evaluated.

China's Banking Transformation takes a generally positive view of what has happened in Chinese banking. Some have protested to me that I am ignoring the costs that China has paid in terms of environmental degradation, cultural heritage loss, increased inequality, etc. There is broad agreement among Chinese and foreigners that these are immense problems, but this book is not about those issues. If I were to write a book on those subjects, it would not be a positive story. This book, however, is about banking, which is a positive story.

Others have warned me that the speed of change occurring in China will make anything I write about banking out of date soon after the book is published. There is some truth in that, and no doubt some things in this book will soon be dated. This book, however, is not primarily concerned with the issues faced by banks in 2016 as the book goes to press, but rather seeks to explain the longer-term role that Chinese banks play in the political economy, to explain how Chinese banks work in ways both similar to and different from Western counterparts, and to demonstrate how the nature of Chinese banking arises out of China's culture and is conditioned by its history. I do not expect that any of these will soon change in China.

This book is based on my accumulated experience and observations over the thirteen years that I have served on the boards of two Chinese banks. To my colleagues on the boards and in the management of the two banks, I owe an immeasurable debt. Through the years they have shared with me their hopes and ideas, frustrations and worries, successes and failures, permitting me to become a "member of the team." As the only foreigner in both banks, I have felt honored and privileged. My position on the boards of these banks has provided me with access that has been available to only a handful of other

foreigners. I hope that the years of experience I have accumulated over a lifetime of banking and which I have shared with my Chinese colleagues has contributed in some way to the development of these banks.

Despite my privileged access, my personal experience of Chinese banking was limited to what I learned from my work on the boards of two banks and, despite my best efforts, was invariably colored by my American cognitive framework. I expanded my understanding and checked the validity of my book's themes through conducting interviews with approximately 150 people, mostly Chinese, but also foreigners, and in a few cases interviewed the same person more than once. People interviewed included banking practitioners, government officials, journalists, academics, economists in multilateral organizations, and businessmen. Interviews were conducted in Chinese and English languages, depending on the preference of my interlocutor. The people interviewed were all knowledgeable and extremely generous in sharing their views and experience with me. They asked only that I be objective in what I write in this book, pointing out both the strengths and weaknesses of the Chinese system. Those who spent time with me in interviews were too numerous to acknowledge individually here, but I want to express my deep appreciation to all of them for the time they took out of busy schedules to share their knowledge and insights with me. Without their assistance this book could not have been written.

I would like to acknowledge my debt to two people in particular. First is Hugh Peyman, who accompanied me on most of my interviews. Hugh has shared with me his great understanding of China's contemporary economy. His critical challenges to my assumptions and beliefs sharpened my own thinking. Michael Yang provided invaluable research support, and Michael went beyond research to also caution me when I was misunderstanding some aspect of Chinese culture or society.

I have also benefited greatly from first learning about Chinese history, language, and culture in America and Hong Kong fifty years ago, studying under great teachers who conveyed not only their knowledge of China but also their passion for the country, its people, its language and its culture—Frederick Mote, Ch'en Ta-Tuan, Joseph Levenson, Frederick Wakeman, James Cahill, Edward Shafer, Liu Ming, and Liu Yamei, among others.

In writing in this book of my experience working within Chinese banks, I have been mindful not to disclose confidential bank and government material to which I had access.

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Abbreviations

ABC	Agricultural Bank of China
AMC	Asset management company
BIS	Bank for International Settlements
BOC	Bank of China
CAS	Chinese Accounting Standards
CBRC	China Bank Regulatory Commission
CCB	China Construction Bank
CIC	China Investment Corporation
CSRC	China Securities Regulatory Commission
DRC	Development Research Council
GAAP	Generally Accepted Accounting Principles
ICBC	Industrial and Commercial Bank
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
IT	Information Technology
MIS	Management information system
MOF	Ministry of Finance
NDRC	National Development and Reform Commission
NPL	Non-performing loan
OECD	Organization for Economic Co-operation and Development

P2P	People to people
PBOC	People's Bank of China
PSB	Postal Savings Bank
SME	Small and Medium Enterprises
TARP	Troubled Asset Recover Program
WMP	Wealth Management Products
WTO	World Trade Organization