VI. THE ROLE OF THE FINANCIAL SYSTEM IN ENTERPRISE REFORMS

Development of China's financial system is essential to the success of reforms to the enterprise sector. While a longer-term effort, substantial improvements are needed in several areas over the next several years if overall progress in enterprise reforms is to be sustained. A major challenge is to transform financial institutions that are now disproportionately focused on SOE to better serve the needs of the growing non-state sectors. Non-state enterprises as well as smaller SOE are now facing severe external financing difficulties. Efforts to improve their financing are focused on adapting existing facilities but have met with limited success so far.

A second challenge is to improve financial discipline of enterprise behaviour. Important progress has been made toward tightening bank lending standards and improving supervisory oversight. However, continued needs to provide credit to support aggregate real growth and sustain SOE until they can be restructured pose risks to the sustainability of improved lending practices. Unless this vicious circle is broken decisively, much of the progress that has been made in improving lending practices and strengthening corporate governance mechanisms could be set back. Development of money and capital markets is important to ensure that financial discipline becomes firmly rooted. These markets are also needed to provide mechanisms for market-based enterprise restructuring, which are still quite limited in China.

Financial reform is now central...

While given a lower priority for much of the reform period, financial reform in China has now become central to efforts to complete the transformation to a market-based economy. This increased emphasis partly reflects the fact that China's financial system has lagged behind the development of the enterprise sectors in terms of its responsiveness to market forces and adaptation to the increasing economic importance of non-state firms. Financial reform has also become essential to, and dependent on, progress on enterprise reforms. Additional impetus for financial reform in China has been given by the Asian crises, which have underscored the fact that major defects in financial systems have led, more often than not, to serious distortions and instability in the real economy (Lindgren *et al.*, 1996; Goldstein and Turner, 1996).

... and critical to the success of enterprise reforms

The basic objectives of China's financial reform are quite similar to those of other transition and developing countries, but the priorities and modalities are heavily influenced by the situation of its enterprises. Two objectives of financial reform are particularly important to improving enterprise performances.

- The first is to adapt the existing financial system, which has been heavily focused on providing financing to SOE, to accommodate the growing non-state sector.
- The second is to establish financial discipline over enterprises in order to reinforce and sustain the development of effective corporate governance mechanisms discussed in Chapter V.

A third important objective, discussed in Box VI.1, is to provide financial mechanisms to promote economic restructuring of enterprises.

Box VI.1. The role of the financial system in promoting industry re-organisation

Financial facilities to facilitate M&A and other re-organisation are still quite limited in China. As indicated in Chapters III and IV, mergers, acquisitions, and other forms of reorganisation are largely initiated and controlled by government agencies. Certain of the asset management and holding companies, such as the Wuhan Asset Management Company described in Chapter V, have begun to promote mergers and acquisitions with enterprises outside their own group, but their activities are still quite limited. The stock markets have served as a catalyst for mergers and acquisitions – nearly 200 occurred among companies listed on the Shanghai Exchange in 1998 alone – but the impact is limited by the narrow segment of institutions that are listed. Further development of the stock markets and increase in the number and range of listed companies should provide a foundation for market based reorganisations as well as help to break down the still considerable barriers to mobility of enterprise operations across provincial boundaries. However more will be needed, including: completion of the corporatisation process so that equity stakes can be transferred; clarification of enterprises' ability to dispose of their assets; and development of investment banking facilities to provide financing and technical advice for business reorganisations.

The recent establishment of the bank asset management (BAMC) companies[1] to work out the NPL of the commercial banks potentially represents an important development in the financial system's role in enterprise restructuring. The key mandate of the BAMC is to maximise recovery value of the assets acquired from the banks.[2] While the scope of their operations remains to be clarified, initial indications after the formation of the first BAMC, Cinda Asset Management Company for the China Construction Bank, suggested that the companies would have considerable flexibility and a range of instruments in dealing with non-performing loans. These include: reorganisation and management changes of indebted enterprises, facilitation of mergers and acquisitions, debt-equity swaps, and resort to bankruptcy in cases of economically unsalvageable operations. The legal and administrative claims derived from the holding of enterprise debt, combined with the backing of central government authorities, potentially give the BAMC considerable leverage to promote restructuring and overcome administrative barriers to its accomplishment.

The initial operations of the BAMC in the latter half of 1999 focused on debt-equity swaps with larger SOE (see Chapter III). The operations have been carried out by the BAMC holding the debt together with the original bank creditor(s) and the enterprise or enterprise group itself. The debt-equity swap agreements have been linked to reforms mandated by the Company Law (in particular establishment of boards of directors and boards of supervisors) as well as reorganisation of operations.[3] However, major changes of enterprise senior management do not seem to have occurred, or at least have not been publicly announced. The agreements also do not seem to have imposed specific ongoing conditions on future performance or implementation of reforms. A provision in the agreements allows the BAMC to sell back the equity to the enterprise after several years if the BAMC would otherwise make a loss, but the degree to which this provision provides any effective conditionality remains to be seen. There is thus a concern that the program is seen as a "free lunch" by enterprises that does little to increase their incentives to improve their operations.

The broader effectiveness of debt-equity swaps in facilitating enterprise restructuring and in maximising the recovery value of BAMC assets remains to be seen. Economically successful reorganisations can involve concerted efforts over time. As holders of fixed income claims that need to be restructured, BAMC in principle have an ongoing influence on the restructuring process. By swapping the debt for equity, the BAMC gain a voice in selecting directors and senior management and in setting the strategic direction of enterprise operations. In practice, this influence is shared with other equity holders, with state asset management companies or government agencies retaining the controlling interest, at least in the case of larger SOE. The influence of the BAMC as equity holder is further limited given that formal claims and powers of minority equity holders in China are, if anything, weaker and less easily enforced than those of holders of fixed income claims. Continued holding of debt or other means may be most effective way for BAMC to promote successful restructuring in some circumstances, while debt-equity swaps are more effective in others. Thus BAMC are likely to need to retain flexibility in their instruments if they are to fulfil their mandate.

1. The four companies are: Cinda AMC (China Construction Bank), established in April 1999; Orient AMC (Bank of China); Huranga AMC (Industrial and Commercial Bank of China); and Great Wall AMC (Agricultural Bank of China). The latter three were established in November 1999. Together the four AMC are due to take on non-performing loans equal to 1.2 trillion yuan, or about 18 per cent of the total loans of these banks to the corporate sector.
2. According to an article published by the Xinhua News Agency (4 November 1999), business activities of the Cinda AMC will involve "… purchasing and performing trust management for non-performing loans accumulated by commercial banks; debt retrieval and restructuring; investment consulting; borrowing from financial institutions and applying to the central bank for re-lending funds; issuing bonds; direct investments; and various activities involving other sectors …." The article also notes that BAMC are authorised in principle to sell debt to overseas investors.
3. A series of well-publicised debt-equity swaps were announced during the second half of 1999 involving large SOE in a range of industries. Indicative examples are agreements signed with Anshan Iron and Steel (Liaoning Province) and Baosteel Group (Shanghai) in November of 1999. These deals, in which all four BAMC were parties, involve substantial reductions in debt loads in return for restructuring arrangements whose details have not been fully revealed.

Commercialisation of bank lending is the top priority

Efforts to accomplish these objectives have focused on the commercial banks. The key priority is to establish commercial principles – based on the ability of a borrower to repay and other objective risks – as the basis for lending decisions, in place of the government mandates and other non-commercial considerations that have shaped credit allocation in the past. This is essential if the soft budget constraints that have led to much of the current problems of enterprises are to be corrected. To accomplish this objective, major priority is being given to: relieving banks of their non-performing loans and bolstering their capital; improving the capabilities of financial institutions to make commercially sensible and prudent lending decisions; and bolstering financial supervisory capabilities to maintain prudential standards within the financial system as a whole. Another important longer-term priority is to broaden and diversify financial outlets by encouraging the growth of financial intermediaries apart from the major commercial banks, and by further developing money and capital markets.

Providing adequate financing for enterprises

Banks dominate the financial system…

The structure of China's financial system is similar in many respects to those of other developing countries in early stages of their financial development (Table VI.1; see also Woo, 1998; Pei, 1998). Most credit is allocated through a bank-dominated system of financial intermediaries whose activities are still fairly segmented (Wu, X., 1995). Money and capital markets are relatively limited in scope and breadth. Although the portion of enterprise financing provided by these markets has been growing, it remains small (Table VI.2). As in other Asian crisis countries, the limited development of capital markets has fostered the growth of enterprise debt levels and has served to concentrate commercial risks on the banking system.

Table VI.1. **Major financial institutions in China**

	Institution type	Number of entities	Main sources of funds	Main loan customers
I.	People's Bank of China (central bank)	1	Government	Commercial banks
II.	Policy banks	3	Government deposits	SOE
II.	Commercial banks			
	A. "Specialised" state commercial banks	4	Individual and enterprise deposits	SOE
	B. Other nation-wide commercial banks	6	Individual and enterprise deposits	SOE; larger non-state enterprises
	C. Regional commercial banks	8	Individual and enterprise deposits	SOE; larger non-state enterprises
III.	Urban co-operative/commercial banks	n.a.	Individual and enterprise deposits	Urban collective enterprises; smaller SOE
IV.	Urban and rural credit co-operatives	5 200[1] (urban) 50 000[1] (rural)	Individual deposits	Urban and rural collective enterprises (including TVE)
V.	Trust and investment companies	240	Government entities and foreign borrowing	Local governments; SOE
VI.	Securities companies	97	Enterprises	Enterprises
VII.	Finance, leasing and insurance companies	n.a.	Enterprises and individuals	Local governments; enterprises
VIII.	Foreign banks[2]	162	Foreign depositors	Foreign-funded enterprises

1. Approximate figures.
2. Including branches and sub-branches of 13 foreign-funded and joint venture banks; and nearly 100 branches of foreign banks, mainly located in Beijing, Shanghai, Tianjin, and other cities in the coastal zone.

Sources: *China Financial Outlook*, 1999; *China Almanac of Banking and Finance*, 1999; Giradin and Ping, 1997; Kumar *et al*., 1997.

Table VI.2. **Sources of corporate funds**

	1995		1998	
	Value (billion yuan)	Share (per cent)	Value (billion yuan)	Share (per cent)
Total external funds raised	1 152	100	1 395	100
Loans from financial institutions	1 014	88.0	1 152	82.6
Funds raised from markets	138	12.0	243	17.4
Bonds	22	1.9	15	1.1
Equity	15	1.3	84	6.0
Commercial bills	101	8.8	144	10.3

Source: *China Financial Outlook*, 1999, p. 57.

... and remain state owned

Three related features of China's financial system are distinctive and have important implications for the development of the enterprise sectors. First, virtually all domestic financial institutions are state-owned. Unlike European transition economies, which moved to privatise their banks and other financial institutions at a fairly early stage (OECD, 1997*b*), presently there are no plans in China to relinquish state ownership of existing financial institutions, although entry of new private institutions is encouraged in principal.

Concentration is exceptionally high

The second distinctive feature is the overwhelming dominance of the four major state-owned commercial banks in credit allocation. These institutions account for 90 per cent of loans provided by the banking system, and nearly three-quarters of total loans to business (Table VI.3). This concentration is very high compared to most other developing and transition economies and well above the concentration ratio normally considered to be compatible with adequate competition.[86]

Table VI.3. **Lending by major classes of financial institutions**
As of end-1998

	Total loans (billion yuan)	Percentage of total	Loans to non-financial sectors (billion yuan)	Percentage of total
Total	8 964.7	100	8 149.3	100
4 major state commercial banks	6 782.5	75.6	6 231.4	76.4
Other commercial banks	655.5	7.3	531.4	6.5
Rural credit co-operatives	953.4	10.6	881.4	10.8
Urban credit co-operatives	462.2	5.1	400.8	4.9
Trust and investment companies	111.1	1.4	104.3	1.3

Source: *The People's Bank of China Quarterly Statistical Bulletin*, various issues.

... as is the focus on lending to SOE

The third distinctive feature is the concentration of financing on SOE. Although the share has declined in recent years, at least 80 per cent of the loans of the major state banks, and nearly 75 per cent of all commercial bank loans, are directed to SOE, while less than 10 per cent go to non-state enterprises.[87] SOE also typically enjoy preferred access to equity and bond market financing. The gap between the SOE share of commercial bank lending (and overall credit raised externally) and their share of output has increased substantially since the early 1980s.[88] In contrast, non-state enterprises including collectives receive only a small fraction of commercial bank lending. TVE receive only limited bank credit: their borrowing, mainly from the Agricultural Bank of China, represents less than 3 per cent of the total loans of the four major state commercial banks. Urban credit co-operatives are the main formal source of external finance for urban collectives and private enterprises, while rural credit co-operatives are the main source of loans to rural private enterprises. Not surprisingly, non-state enterprises, with the exception of foreign-funded businesses, rely noticeably more on internal funds to finance their investment than do the SOE (Table VI.4).

Equity markets are another funding source

Development of the stock markets in China is intended in part to broaden and augment financing sources for enterprises (Box VI.2). China's enterprises raised nearly 6 per cent of their total external funding[89] in 1997 from equity issues, although a substantial portion of those issues were sold on the Hong Kong and several other foreign stock exchanges. In terms of the overall stock market capitalisation ratio (Table VI.5) and the portion of their external funds raised from the markets, the size of China's stock markets is approaching that of a number of OECD countries. However, nearly all the listed firms are large SOE. Access to the domestic bond markets, which are relatively underdeveloped, is also mainly confined to larger SOE.

But financial outlets for the non-state sector remain narrow

The concentration on SOE has left the most rapidly growing enterprise sectors dependent on a narrow segment of the formal financial sector. This situation has imposed certain handicaps: in particular, non-state enterprises tend to be more vulnerable than SOE to cyclical downturns or (in the case of foreign-funded enterprises) to sudden reductions in foreign capital inflows.[90] However, several factors have partly offset the limited access to funding and allowed non-state enterprises to flourish. First, since non-state enterprises are on average smaller and more labour intensive than SOE, their demand for

Table VI.4. **Enterprise investment by financing sources, 1998**

	SOE	Collectives	*of which* TVE	Individually owned
Total investment (billion yuan)	1 536.9	419.2	323.3	374.4
Source (per cent of total funds raised)[2]				
State appropriations	7.0	2.2	2.8	0.0
Domestic loans	23.3	15.3	13.7	6.4
Foreign sources	4.3	6.4	7.4	0.1
Own sources	49.9	57.0	58.4	84.9
	Jointly owned	**Share-holding**	**Foreign-funded[1]**	**Hong Kong, China/Macao, China/Chinese Taipei funded**
Total investment (billion yuan)	6.0	194.7	164.0	133.4
Source (per cent of total funds raised)[2]				
State appropriations	0.5	0.9	0.1	0.2
Domestic loans	29.4	30.3	12.9	18.9
Foreign sources	1.3	9.0	56.1	43.4
Own sources	57.5	44.0	22.4	23.1

1. Excludes economic units funded by entrepreneurs from Hong Kong, China; Macao, China; and Chinese Taipei.
2. Excluding miscellaneous and unallocated funds. Hence the proportions do not add to 100 per cent.
Source: *China Statistical Yearbook*, 1999.

Box VI.2. **Development of the stock markets in China**

In the early 1990s, China became the first transition country to establish a formal stock exchange by opening two national stock exchanges. The Shanghai Securities Exchange and the Shenzhen Securities Exchange were formally opened in December 1990 and in July 1991, respectively. By the end of 1999, some 912 firms – mostly large SOE – were listed on the two national stock exchanges and the overall stock market capitalisation reached about one third of China's GDP. The development of China's stock markets has been hampered by excessive government control, segmented market structure (see below), insufficient liquidity, lack of transparency, and an underdeveloped legal and regulatory framework. More recently, however, the authorities have been accelerating efforts to develop and better regulate the stock markets. The major motivation behind these efforts is twofold: to broaden and augment financing sources for SOE; and to strengthen external financial discipline and the corporate governance of large SOE.

Listing procedures and share structure

Until very recently, the operation of China's stock markets had remained subject to extensive administrative control and intervention. The access to the stock markets was strictly controlled by the State Council, which decided the number of firms to be listed and the amount of capital to be raised. Each province was subsequently given a quota of new listings, and the selection of firms to be listed was influenced greatly by political considerations at the provincial level. This practice was ended in principle by the recent decision to give China Securities Regulatory Commission (CSRC) sole responsibility for decisions concerning initial public offerings (IPO), thereby taking away provincial authorities' ability to manipulate the listing procedures. Before their IPO, companies are required to implement the changes mandated by the Company Law and undertake the restructuring process required by CSRC. Private companies have largely been prohibited from either listing or assuming majority control of listed firms through market takeover. Firms in the non-state sectors represent only about 3 per cent of domestically listed companies and comprise less than 10 per cent of market capitalisation.

As in other countries, China's stock markets consist of the primary market where firms make their initial offering, and the secondary market where the stocks are traded. There are various types of shares issued in China, including: state shares (owned by the state); legal person shares (owned by corporate or other institutional units with legal person status, and which in practice are mainly state-owned); individual shares (owned by individual Chinese citizens, also known as A-shares); and domestically-listed foreign-held shares (available only to foreigners, known as B-shares). The government has attempted to maintain a rigidly segmented securities market (between A-share markets and B-share markets) because of concern about potential evasion of foreign exchange controls. State-owned shares include shares directly owned by state agencies and those owned by legal persons. The trading of directly state-owned shares on the secondary market is prohibited and that of legal person shares is mostly confined to other legal persons. Thus, state-owned shares constituting nearly two-thirds of all shares issued are effectively removed from active secondary trading, significantly limiting the liquidity of the secondary market in China.

The regulatory framework

The CSRC and State Council Securities Commission (SCSC) were established in October 1992, with the aim of strengthening regulation of the securities market. Since then, the CSRC had been strengthened and in 1998 it was granted sole power for securities market regulation and supervision, after being merged with the SCSC.

China's first Securities Law was adopted in December 1998 and took effect in July 1999. The passage of the Law represents a major step toward well-regulated, transparent securities markets in China. Among other provisions, the Law imposes greater discipline on and more clearly defines the obligations of market participants, including listed companies, their directors and officers, underwriters, brokers, dealers, and law and accounting firms. It also stipulates transparent procedures for examining and approving applications for stock issuance and listing, toughens penalties on false disclosure and improper trading activities, forbids brokerage firms from mixing their own and clients' money to trade shares, and bans banks and SOE from speculating on the secondary market.

There was also an important amendment to the 1985 Accounting Law, aimed at "restoring the independence of accounting activities and increasing the transparency of accounting information". Under the new law, company managers, rather than accountants, are held legally responsible for the truthfulness of accounting information, while the accountants are to be responsible in their own professional capacity rather than acting on behalf of the state and the enterprise. The law also stipulates higher standards for accounting information released by listed companies. The CSRC has also announced new rules strengthening disclosure requirements in other areas, such as board decisions relating to dividends, explanations of corporate decisions to not declare dividends, and more disclosure of large transactions. The CSRC has also required firms to publish annual reports on-line in addition to the newspaper announcements that were formerly required.

Table VI.5. **Comparative stock market statistics**

1997 data except as otherwise noted

	Stock market capitalisation/GDP (%)	Number of listed firms
China	24 (1998)	912 (1999)
Korea	29 (1996)	748 (1998)
Thailand	15	431
India	34	5 843
Indonesia	7	282
Mexico	39	198
Brazil	31	536
Japan	66	2 387
Germany	39	700
United States	144	8 851

Sources: World Bank, *World Development Indicators*, 1999; *China Financial Outlook*, 1999.

external funds is relatively less. Second, enterprises in a number of other developing countries, such as Russia and Mexico[91] seem to have been able to grow substantially without having much access to bank credit or other formal established financial intermediaries. This success is partly attributable to the availability of informal financing facilities, such as inter-enterprise lending and the "curb" markets that became major sources of financing in Korea during the 1980s. Anecdotal evidence suggests that such informal financing channels, which are not officially sanctioned, are very active in China. Third, the relatively lax lending standards that have prevailed in the financial system, together with the substantial influence of local government officials over lending decisions, have partly offset the otherwise less favourable access of collectives to bank loans.

Lending standards have tightened…

This situation has changed greatly in recent years as a result of financial reforms to commercialise bank lending and improve prudential standards (see next section). Bank lending standards have become noticeably more stringent. As a consequence, bank credit has become much more difficult to obtain for a substantial segment of the enterprise sector. Credit availability to larger SOE, particularly those designated to form the strategic core of the public sector, has been least affected by the change. Partly because they retain the implicit financial backing of the government, these enterprises continue to be accorded preferential status in bank lending and enjoy relatively greater access to other credit channels.

… leading to a credit squeeze on non-state firms and SME-SOE

However, numerous reports indicate that collectives as well as smaller SOE are encountering great difficulty in obtaining new bank loans (see World Bank, 1999; Chen, 1999). Their difficulties stem not only from the reluctance of bank lending officers to extend loans to enterprises that do not, for most part, enjoy the access to government funds, implicit government guarantees or other preferences given to many large SOE. A large fraction of small and medium-sized SOE and collectives are either not creditworthy, or are only marginally creditworthy by virtue of their high debt loads and low, or negative profitability. Even in the case of creditworthy smaller SOE and non-state firms, lack of experience in credit assessment together with limited accounting systems and the poor transparency of enterprise accounts makes it difficult for loan officers to identify the good credit risks.

Bank lending growth has slowed sharply

While difficult to gauge in the aggregate, the "credit crunch" faced by China's enterprises as a result of these conditions appears to be significant. One indication is the marked slowdown in total bank lending that became evident in the latter half of 1997, following the formal suspension of credit quotas at the beginning of that year. The slowdown seems too abrupt and pronounced to be fully explained by the more gradual decline in nominal GDP growth since 1996, and suggests restrictions on credit supply have played a role. Other evidence (Chen,1999) indicates that credit limitations have impeded growth of TVE in recent years.[92]

Steps are being taken to improve credit availability…

Authorities have been taking a number of steps to improve credit availability in the near term and to broaden financial outlets for non-state enterprises over the longer term. Beginning in 1998, the commercial banks were given a mandate to develop special facilities for lending to creditworthy SME. However, these facilities do not seem to have greatly eased the funding squeeze faced by these enterprises. More recently, authorities have sought to increase liquidity of smaller commercial banks and other lending institutions that are generally better ending positioned to evaluate creditworthiness of smaller enterprises. Some of the lending authority taken away from local bank offices during earlier reforms has also been reinstated in order to alleviate bottlenecks arising from the concentration of decisions in higher offices. Regulations are also being relaxed to allow SME to issue corporate bonds, although larger enterprises still have the preferred access to what is still a fairly small market.

… including credit guarantees

Beyond the near term, credit guarantee mechanisms are seen as a major instrument for improving the access of SME to credit. A number of provinces and cities are experimenting with a "mutual" guarantee system funded by the enterprises and supplemented in some cases by contributions from local governments.[93] Several of the organisational forms envisaged in the divestiture of smaller SOE, notably leasing and contract forms, should help to encourage further development of inter-enterprise funding mechanisms. Some academic experts have also advocated development of an over-the-counter market to provide access to equity financing for small- and medium-sized SOE as well as non-state enterprises.

Longer-term priorities: increase bank lending to non-state enterprises…

Nevertheless, these steps are unlikely to be sufficient to provide the funding facilities that will be needed as more enterprises shift to the non-state sector and state control shrinks to the strategic core. The longer-term strategy to provide these facilities has three elements. The first is to continue to facilitate and encourage expansion of lending by the larger state commercial banks to non-state firms. The large banks probably have adequate incentives to lend to creditworthy non-state enterprises; however given their bureaucratic structure and traditional orientation toward SOE, these banks are not especially well placed to identify good credit risks among such firms.

… foster growth of other financial institutions…

The second element is to foster the growth of the commercial banks and financial institutions with the greatest comparative advantage in lending to SME and non-state enterprises. The recent permission granted to two regional banks (Pudong Development Bank and Shenzhen Development Bank) to list on the stock market is seen as an initial move by authorities to provide additional capital that will be needed for expansion of these institutions.

However, the institutions will also need to be able to increase their funding base, which in turn will depend upon further development of interbank and other markets for wholesale deposits.

... and increase foreign participation

The third element is to expand participation by foreign banks and other foreign financial institutions. These institutions, either through wholly owned operations or through joint-ventures with existing domestic institutions, may ultimately come to play an important role in financing the enterprise sector once the financial opening provisions mandated by China's recent agreement with the United States government on WTO entry come into effect. However, as the experiences in several OECD countries such as Japan and Korea have shown, the capacity of foreign banks to engage in lending to enterprises depends on their access to local currency funding. Given the difficulty and expense of setting up retail deposit networks, this access will depend critically on their ability to attract enterprise deposits and to tap the domestic money markets.

Establishing financial discipline

Financial discipline is essential to effective corporate governance

The incentives provided by the financial system, together with competition in product and factor markets, are critical to the external environment that determines whether ownership structures, boards of directors, and other mechanisms of corporate governance result in economically efficient enterprise behaviour. A number of serious financial and macroeconomic problems experienced by OECD countries during the 1980s and 1990s can be traced to breakdowns in financial discipline. Examples include: the savings and loan crises in the United States; the real estate bubbles and excessive debt accumulations during the late 1980s in the United Kingdom and several Nordic countries, which subsequently led to severe recessions in the early 1990s (Edey and Hviding, 1995); and the property market bubbles in Japan during the latter 1980s. Similar distortions in the financial system, aggravated by deficiencies in accounting and credit assessment systems and poor transparency of enterprise operations, were also major contributors to the 1997 crises in several Asian countries (World Bank, 1998). Together with improved corporate governance, financial discipline will be critical in determining whether the near-term gains from economic restructuring in China are translated into sustained improvement in enterprise efficiency and profitability.

"Soft" credit from banks has caused major problems

While product market competition is reasonably well established in the majority of industries (World Bank, 1994), China's financial system has retained vestiges of the central planning regime that have largely prevented it from providing the oversight and financial market discipline necessary for efficient enterprise behaviour. The most serious defect has been the use, until recently, of banks as quasi-fiscal agents to provide "soft" credit based on central or local government plans (Lardy, 1998; Steinfeld, 1998; Gao and Schaffer, 1998). The provision of soft credit was a key factor in the excessive and inefficient investment and excessive debt accumulation that occurred during the investment boom of 1993-1995 (Wu, J., 1995). As indicated in Chapter II, increased management autonomy appears if anything to have aggravated these problems by affording enterprises greater freedom to respond to the perverse incentives in the financial environment. That the financial environment is essential is further supported by evidence, cited in

Chapter V, that enterprises that have gone furthest in governance reforms often perform more poorly than those less far along in those reforms.

Financial intermediaries and markets are both necessary…

Debate continues in the literature as to the elements of the financial system that are most necessary to sustain good corporate governance. Financial markets, particularly the equity market, play a major role in Anglo-Saxon countries while banks play the key role in continental Europe and Japan. In China as well as other developing countries, the question is not whether to develop one or the other. Both are ultimately necessary, but there remains a question of the priority to be given to their development.

… but financial markets in China are limited…

However, financial markets that can exercise effective oversight take some time to develop. Admittedly, the stock markets have provided, through their listing requirements, incentives for companies to improve disclosure and implement corporate governance reforms.[94] However these incentives are blunted by the relatively small number of firms admitted to the market each year as well as by the predominance of small investors with limited experience and resources for evaluating the performance of the listed companies.[95]

… and banks are the key to effective discipline in the medium term

Two further considerations suggest that reforms to improve the effectiveness of the banking system, and to a lesser extent other financial intermediaries, are likely to be most critical to improving enterprise performance in the circumstances that China is likely to face for much of the next decade. First, limited information and lack of transparency concerning enterprise operations hamper effective oversight by open financial markets and increase the comparative advantage of "insider" financial stakeholders, notably banks. A second and more practical consideration is that the process of working out large non-performing loans of the enterprise sector unavoidably affects the relations between banks and their business customers and requires special attention to restore the incentives for banks to provide financial discipline. These considerations are supported by historical experience; in particular, financial reform efforts in Eastern European transition countries have given greatest emphasis to establishment of effective market-based banks and other financial intermediaries in the initial stages (OECD, 1997*a* and 1997*b*; Blommestein and Spencer, 1994).

Financial discipline rests on a credit culture

Development of an internal "credit culture" is the fundamental requirement if financial intermediaries are to exercise effective discipline over enterprise behaviour (see Group of Ten, 1997). A credit culture means that ability to repay is the overriding consideration in extending loans and risk is the primary factor shaping the terms on which loans are made. Creation of a credit culture requires good corporate governance of the financial institutions including: management accountability; effective internal controls and incentives to accurately assess risk; and effectively functioning boards of directors and other mechanisms to ensure that managers act in the interest of owners. In addition to these requirements, an effective system of prudential supervision and oversight is essential if the financial system is to remain stable and provide the proper incentives to enterprises. Identifiable failures in the regulatory process, ranging from severe moral hazard to lax oversight of financial institution practices to excessive forbearance in addressing known problems, have figured prominently in nearly all the major financial crises cited earlier.

Financial discipline is impaired by limited capability…

In China, the establishment of a credit culture has been greatly impaired by three factors. First, the *capability* of financial institutions to maintain prudent lending standards has been constrained until recently by the use of the four major banks to extend loans on the basis of non-commercial criteria (Cheng and Cheng, 1998; Bouin, 1997). Officially designated "policy loans" include government directed credit to designated sectors or projects regardless of the objective creditworthiness of the borrower or the commercial viability of the project. However, a substantial further portion of bank loans are effectively policy loans. Local officials, who have had considerable influence over the local offices of the commercial banks,[96] have been able to divert lending to speculative or other commercially questionable projects. Banks typically have been required to supply credit to allow loss-making SOE to maintain their operations and pay their workers.

… and poor incentives and information

Second, *incentives* to maintain a credit culture have been severely blunted by the dominance of formal and informal policy lending and by the fact that the banks are themselves state-owned institutions in which profit and avoidance of losses have traditionally been viewed as (at best) secondary priorities. Incentives to hold enterprises accountable for their obligations have been further limited by the lack of effective legal and administrative mechanisms, in particular foreclosure and bankruptcy, for enforcing loan contracts. Third, lack of *information* further impairs the credit culture of financial institutions. Information necessary for effective credit assessment and monitoring of loan performance is, as in many developed countries, severely limited by inadequate accounting systems and generally poor information available about enterprise performance. Particularly for the largest commercial banks, the large number of branches spread over a wide and diverse geographic area makes it difficult for senior management to maintain adequate internal controls; and also complicates the task of central bank supervisors in maintaining effective oversight.

High NPL levels greatly aggravate the problems

These deficiencies have been greatly increased by the high level of non-performing loans (NPL) of the major commercial banks. According to official figures, NPL are around 15-20 per cent of the total loans of the four major commercial banks; but outside estimates suggest they could be more than twice as large (*e.g.* Lardy, 1998). Maintenance of sound lending standards is exceedingly difficult under such circumstances: international experiences indicate high NPL levels reduce incentives for banks to rigorously assess credit worthiness, monitor loan performance, or enforce loan contracts (Lindgren *et al.*, 1996).

Extensive efforts are being made to address the weaknesses

Since 1995, extensive reforms have been underway to establish sound lending standards and improve prudential standards. In that year, three new specialised ("policy") banks were established to take on the policy loans of the commercial banks. A new banking law that came into effect in 1996 made bank management accountable for loan performance. In 1997, the central credit plan (the system of credit quotas for the major commercial banks and their branches used for credit allocation) was formally abolished. These steps have been accompanied by measures within the commercial banks to implement sound lending practices. These include: the use of internal credit rating standards based on enterprise credit history and financial conditions; and the establishment of strict accountability of individual loan officers and their senior managers for containing non-performing loans.[97] To reduce the undue influence of local government officials, authority for granting loans was shifted from local offices to provincial head offices; although, as noted earlier, this policy has since been partially reversed.

NPL are being addressed

A major further step was taken in 1999 with the establishment of four bank asset management companies (BAMC) to take on the non-performing loans of the four major commercial banks that were incurred before 1996.[98] The BAMC are authorised to acquire 1.2 trillion yuan of NPL, amounting to nearly 18 per cent of the total loans of the four major commercial banks. Establishment of separate entities to deal with NPL allows more flexible means to work out the loans,[99] and is consistent with "best practices" as they have emerged from international experiences.[100] However, the portion of NPL being transferred is significantly below outside estimates of their level, and does not provide any explicit accommodation for loans that become classified after 1995.

Accounting and loan classification systems are being upgraded

Considerable effort is also being made to address deficiencies in information needed to assess credit worthiness and monitor loan performance. These include programmes to upgrade accounting skills and standards. To further improve bank lending standards and practices, a new loan classification system was introduced on an experimental basis by the People's Bank of China (PBOC) in 1996. This system is based on international standards and, in principle, is more "forward looking" in identifying potential problem loans than the essentially backward-looking system that has been used traditionally.[101] Commercial banks have also been given somewhat greater flexibility to vary interest rates from official benchmark levels in order to better incorporate risk in loan pricing.[102] An important further step is the development of a national "credit registry" system under the auspices of the People's Bank of China together the commercial banks similar to those used in Germany, Italy, and several other European countries. The purpose of the credit registry is to provide information to potential lenders about the outstanding loans, credit history, and financial performance of loan applicants.[103]

Financial supervision is being strengthened

Finally, steps have also been taken to upgrade financial supervisory capabilities and improve prudential standards of non-bank financial intermediaries. Under the 1999 reorganisation of the PBOC, supervisory oversight of local commercial bank operations was shifted from the central bank's local and provincial offices to nine nearly created regional ("mega") branches. The intent is to further reduce the undue influence of local governments on credit expansion. PBOC supervisory authorities have also moved forcefully to strengthen supervision and curb financial abuses. They have moved to curtail unsanctioned activities of trust and investment companies (and closed several) and forced banks to divest their trust and investment company subsidiaries. They have also converted urban credit co-operatives into commercial banks subject to banking sector regulations; and are moving to tighten supervision of the operations of rural credit co-operatives, which are reported to be in serious financial difficulties.[104]

Overall, important progress has been made

Taken as a whole, these financial reform measures taken so far represent important and necessary progress toward establishing financial discipline. There is widespread agreement that loan standards and credit quality have improved significantly since 1996. The information needed to sustain these standards should improve further as accounting, loan classification, and other financial control systems mature. Efforts to improve supervision and curb financial abuses should also help to bolster financial discipline, as well as reduce threats to financial stability.

But further measures are needed to sustain progress…

However, important as they are, the present measures are unlikely to be sufficient by themselves to ensure that the improvement in financial discipline goes far enough, or even that existing gains will be preserved. Establishment of governance structures for the commercial banks is only beginning. As indicated in Chapter V, further liberalisation and development of capital markets will be needed before they can serve as a major force for good corporate governance or financial discipline. In addition to these necessarily longer-term processes, there is a pressing need to relieve two key and closely related bottlenecks that threaten to halt or even set back current reforms.

Bottlenecks need to be relieved soon in two areas: ending policy lending…

First, despite official intentions, there are several reasons to believe that state commercial banks continue to make substantial amounts of policy loans – that is credits that do not satisfy rigorous commercial standards but are extended for other reasons – even if they are not explicitly designated as such. Given the large fraction of SOE that are making losses, aggregate loan growth is stronger than would be expected if sound commercial loan standards were being rigorously applied across the board. In 1998, commercial banks were required to provide matching loans to supplement the government's infrastructure spending programme.[105] Periodic statements by government officials urging banks to increase lending for technical purposes, or to support restructuring in particular sectors, also suggest that the transition to commercial lending standards remains incomplete.[106] This situation reflects the fact that the fundamental conditions underlying policy lending and the use of bank loans for fiscal purposes, namely scarce government financial resources and the financial weakness of a large segment of enterprises, persist. However, continued policy lending undermines and limits the effort to instil rigorous lending standards by sending mixed messages to loan officers and senior bank management. If continued, it is also likely to erode lending standards and circumscribe any gains in financial discipline.

… and completing the resolution of bank NPL

Second, despite its substantial scale, the current programme to work out bank NPL is unlikely to prove sufficient. The experience of OECD as well as many non-OECD countries indicates that the existing stock of bank NPL needs to be dealt with fully and decisively, and the fundamental factors that led to the NPL ("flow problem") corrected, if banking sector financial problems and their repercussions are to be resolved in a lasting fashion (Lindgren *et al.*, 1996; Goldstein and Turner, 1996). Neither condition has yet been met in China. If outside estimates of NPL are at all accurate, substantial amounts of loans remain with commercial banks that are likely to prove non-performing in the future. Moreover, continued policy lending indicates that the underlying factors behind the growth of NPL have not been fully eliminated. While it is too early to assess whether NPL on bank books will again grow to critical levels, experiences of other countries indicate that banking sector problems are very likely to recur in such circumstances. For example, banks in Hungary had to be recapitalised on four successive occasions during the first half of the 1990s (OECD, 1997*b*). Moreover, current measures will at best only partially restore the financial soundness of the major banks. Evidence suggests that such partial restorations tend to do little to raise bank incentives to maintain sound lending standards or effective loan monitoring (Aghion, Blanchard and Carlin, 1994).

Government control of the largest banks poses special problems

Finally, although perhaps not as critical in the near term, the close government control of the four major commercial banks, although it may have helped in improving lending standards in the near-term, is also likely to complicate the task of sustaining financial discipline by banks over the longer-term. Until recently, the banks had not participated in the corporate governance reforms described in Chapter V. Authorities did announce in early 2000 that supervisory boards would be established for the four major banks and are considering means to diversify their ownership somewhat. However, even if the current weaknesses of these mechanisms discussed in Chapter V were to be addressed, the dominance of the four banks in credit flows and their central place in the economy will make it difficult to fully eliminate non-commercial considerations from bank lending.

Concluding observations

Overall, significant progress is being made

As has often happened in rapidly growing economies, development of China's financial system has lagged behind that of its enterprise sector. As the measures cited here indicate, authorities have been moving vigorously and on a broad front in recent years to redress this gap. The steps that are being taken to achieve these goals are already showing some positive benefits. Provided they can be sustained, these efforts should help significantly in correcting the distortions that have adversely affected enterprise behaviour in the past, and in reinforcing the reforms to corporate governance mechanisms discussed earlier.

But several weaknesses need to be addressed…

Nevertheless, there are important gaps in current reforms as well as tensions among some of their objectives that remain to be resolved. Although ultimately intended to reduce disparities in financial treatment among enterprises, the effect so far has been to increase them. Financial discipline for non-state enterprises and smaller SOE has increased significantly, but (partly for that reason) their access to credit has worsened. Debt-equity swaps and the development of the stock market have effectively increased the preferential credit access of larger SOE (particularly those destined to remain under government control) and tend to blunt the effects of improved financial discipline from the banks. Banks in any case face greater difficulties in applying stringent lending standards to large SOE than to smaller SOE or non-state enterprises. As with corporate governance, substantial further progress on financial reforms will be needed to sustain the progress that has been made and to ensure that the near-term gains from economic restructuring are translated into long-term improvements in enterprise performances.

… and rapid progress needs to be made in two key areas

The prior discussion suggests that substantial progress within the medium term is particularly needed in two key areas to maintain progress in the overall reform process. First, it is not yet clear whether the efforts to adapt existing financing mechanisms will be sufficient to alleviate the credit crunch non-state enterprises and smaller SOE are now facing, or to allow these segments to realise their growth potential over the longer term. Entry of foreign and new domestic institutions should improve financing facilities for the non-state sector, but the improvement is likely to be gradual and will depend on the development of the inter-bank and other facilities needed to provide the funding base for the new entrants. In the meantime, a more active and comprehensive approach to improving financing for smaller SOE and non-state enterprises will be needed if present restraints on credit supplies do not ease, or worsen. As suggested in Chapter III, acceleration and expansion of existing experimental programmes to provide credit guarantees or loans to creditworthy smaller SOE and non-state enterprises would help in this respect and need not involve substantial direct budgetary costs in the near-term.

Ending non-commercial bank lending is essential

Second, it is essential that the vicious circle underlying the continuing need to provide policy loans be decisively broken and soon. Otherwise, the current tightening of bank lending standards is unlikely to be sustained, banks' financial health is unlikely to continue to improve and could worsen again, financial discipline is likely to remain highly uneven and weak overall, and the effectiveness of corporate governance reforms will be seriously compromised. The key requirement is to end remaining commercial bank lending to enterprises that are not creditworthy, with alternative forms of support to the enterprises provided where necessary. Some expansion of the current programme to deal with bank NPL may also be necessary if, as is quite possible, substantial amounts of such loans remain in commercial bank portfolios.

- The most effective approach would be to end remaining policy lending by the commercial banks and to apply strict lending standards across the board to all enterprises regardless of their status or condition. Under this approach all loans failing to meet strict commercial standards but deemed necessary for other reasons would be transferred to the policy banks, whose operations would then have to expand. If this cannot be done in present circumstances, a second best approach would be for bank management and supervisors to explicitly identify and acknowledge loans made for non-commercial purposes (*i.e.* those not meeting strict commercial lending standards), in order to effectively segregate such policy lending from the normal commercial lending process.
- Given the significant risk that the NPL problem could re-emerge, authorities may also need to consider expanding the present programme to allow loans classified as NPL in the initial stages of the 1996 banking reform (say 1996 and 1997) to be transferred to the BAMC. However, it is very important that any such modification be done on a "one time only" basis so that banks' responsibility for sound lending is not impaired.

Longer term challenges: the governance of state banks...

Over the longer term, the government ownership and exceptional dominance of the major state commercial banks presents particular challenges to financial reforms in China. The problems other countries have encountered in maintaining effective governance of state-owned banks raise questions about whether the major commercial banks in China will be able to maintain prudential standards and exercise effective financial discipline over enterprises, while at the same time serving as the "lead banks" for the strategic core of SOE and developing their facilities for financing non-state enterprises. The present policy is to promote development of existing and new financial institutions to increase competition while relying on supervisory authorities to prevent any backsliding in prudential standards. However, more comprehensive restructuring of the banking system, including the four major commercial banks, will deserve consideration for the next phase of reforms.

... and accelerating the development of financial markets

Finally, the development of domestic capital markets is important to allow enterprises to improve their capital structures and to reinforce the financial discipline provided by banks and other financial intermediaries. Better developed financial markets are also needed to reinforce financial discipline on enterprises, particularly given the risks to the banks' effectiveness in this regard posed by dominant state ownership. While the stock market has been growing rapidly, the overall approach to developing the capital markets has been one of gradualism. Their impact on the enterprise sector as a whole is limited by the narrow range of participants permitted on both the supply and demand sides of the markets. A more rapid approach to development could help to encourage efforts by enterprises to reform their governance structures and improve transparency, as well as to develop market mechanisms for facilitating industry restructuring.