Will China's Four Major Banks Succeed in Going Public?
– Establishing Corporate Governance Will Be Impossible if They Remain under State Control

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China's four major state-owned banks (the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China and the China Construction Bank) are aiming to list on overseas equity markets, and this plan is viewed as the most important issue for financial reform. It aims not only to broaden fund procurement channels for the banks, but also to establish corporate governance structures suitable for a market economy. However, judging from the fact that other state-owned enterprises that have already gone public are not doing that well, I cannot help but say that realizing this scenario will be very difficult.

In order to make listing a reality, the banks must shore up their capital bases and resolve the problem of the non-performing loans they have amassed. The government injected 270 billion yuan into the four major banks in 1998. The following year, it purchased some 1.4 trillion yuan worth of non-performing loans from the four banks at book value and transferred them to four newly established asset management companies. Furthermore, at the end of 2003 the authorities pumped $45 billion in foreign reserves into the capital bases of the Bank of China and the China Construction Bank. Thanks to such measures, the ratio of non-performing loans to total lending at the four major banks has fallen from more than 25% at the end of the 1990s to 15.7% as of September 2004.

However, it would be too early to conclude that the non-performing loan problem has been resolved. Without eradicating the reason behind the creation of non-performing loans - the lack of corporate governance at the banks and the state-owned enterprises that are their main borrowers - no matter how much public money is pumped into banks, it cannot catch up with the growth of new bad loans. If the authorities start to help banks without much thought, it would aggravate moral hazard, and non-performing loans would increase uncontrollably. What is more, as the Chinese economy moves from overheating to an adjustment phase and the businesses of borrower firms slow down, it is feared that banks' non-performing loans will further increase. In addition, in order to go public on overseas markets, the banks will have to undergo assessments in line with international standards, which are more stringent than domestic rules, and there is a good possibility that the amount of non-performing loans they shoulder will be larger than that reported in their self-assessments.

In moving toward listing, the Chinese authorities have drawn up a three-step strategy to reform the four major banks. In the first stage, the banks are to strengthen their internal management and risk management so as to become modern financial institutions that have comparatively strong international competitiveness. This would be followed by the second stage, in which they would be transformed from being 100% state-owned to joint-stock banks with the government as the major shareholder, and in the final stage these joint-stock banks would be listed on overseas equity markets. As a step symbolizing the transition toward the second stage, on August 26, 2004 the Bank of China was relaunched as "Bank of China Limited". However, it is doubtful whether the bank had actually achieved the first-stage target, and even if it rushes to move to the second phase, it will have to clear many more hurdles before it can go public. As a matter of fact, at the August 26 news conference, Bank of China President Li Lihui unveiled the outlook that because "there is a need for management quality to meet the standards for listed firms," the bank would not be listed any earlier than the latter half of 2005.

In order for "management quality to meet the standards for listed firms," banks must have the ability to achieve the rate of return expected by investors - in the words of Beijing University Professor Lin Yifu, they must be "viable." At present, the four major banks are all saddled with a huge number of employees and a mountain of non-performing loans. Despite repeated non-performing loan disposals and capital infusions using public money, their revenues per employee and return on assets are both still very low. The weakness of their operations becomes clear when they are compared with the world's top banks, which are becoming strong competitors even within China (table). Without government support on the policy and financing fronts, the four major banks, far from being profitable, would be insolvent.

The essential reason why managerial efficiency and profitability are low at the state-owned banks can be found in their lack of corporate governance during the transition from a planned economy to a market economy. As in the case of other state-owned enterprises in China, the state has failed to play its role as the shareholder effectively. Because their supervisors and managers are government-appointed bureaucrats, many state-owned companies, even after they become joint-stock companies and are listed on stock exchanges, lack a mechanism for bodies like shareholders' meetings, boards of directors and audit committees - which are required as under the modern corporate system - and company managers to keep each other in check, even if such bodies are created as a formality. Also, at each level of government, especially at the local level, state-owned banks see intervention in various business activities, including personnel and financing, and the evils of "mixing up administrative and business functions" are becoming serious. Even after the Export-Import Bank of China, the State Development Bank and the Agricultural Development Bank of China were created in 1994 to specialize in policy-related lending, state-owned commercial banks still had to agree to extend huge amounts of policy-related loans, and this has been a reason why their non-performing loans have continued to increase.

Indeed, the aim of listing state-owned banks is to try to solve these problems by diversifying ownership. However, as can be seen from the behavior of state-owned firms that have already gone public, it will be difficult to establish corporate governance at the four major banks if the state continues to hold a majority of their shares. In fact, the return on equity of China's listed firms has followed a downward trend, and this has brought about a stock market slump. The problem lies in the fact that their managers continue to conduct business in a way that places priority on their own interests rather than those of ordinary investors, who are minority shareholders, even after the firms are listed.

Public ownership and a market economy are incompatible to begin with. In order to establish corporate governance suitable for a market economy, the government must not stop at listing the state-owned banks, but in the end it must also fully withdraw from their ownership and management through "privatization." Through this, it becomes possible for domestic and foreign investors with a strong interest in the banks' management to become major shareholders while enabling the government to dispose of the non-performing loans that were separated from the banks using the proceeds gained by selling off its shareholdings.

Needless to say, in the course of privatization the government must prevent insiders such as senior executives of the firms from illegally appropriating state-owned assets, which are essentially owned by the people, for their own use. As a matter of fact, irregular accounting and false reporting are rampant at state-owned companies that have gone public, and there is no end to scandals related to fund procurement and transactions among related businesses. This is shaking trust in China's capital markets. Because the four major banks form the pillars of China's financial system, the authorities must strengthen their supervision of them, including improvements on the legal front, so as to maintain stability in the economy as a whole.

Table: Banks in the Fortune Global 500

Banking industry ranking	Global 500 ranking	Company	Revenues ($million)	Total assets ($million)	Profits ($million)	ROA (%)	Employees	Revenues per employee ($)	Profits per employee ($)
1	18	Citigroup	94,713	1,264,032	17,853	1.4	256,000	369,973	69,738
2	45	Credit Suisse	58,957	777,958	3,717	0.5	60,837	969,099	61,096
3	47	HSBC Holdings	57,608	1,034,216	8,774	0.8	218,000	264,257	40,248
4	48	BNP Paribas	27,272	987,717	4,257	0.4	89,071	306,180	47,789
5	51	Fortis	56,695	659,991	2,487	0.4	62,565	906,181	39,749
6	67	Deutsche Bank	48,670	1,013,623	1,545	0.2	67,682	719,104	22,826
7	71	Bank of America Corp.	48,065	736,445	10,810	1.5	133,549	359,905	80,944
8	72	UBS	47,741	1,120,650	4,747	0.4	65,929	724,127	72,008
9	78	Credit Agricole	45,928	1,103,964	2,971	0.3	136,446	336,603	21,773
10	81	JPMorgan Chase	44,363	770,912	6,719	0.9	93,453	474,709	71,897
29	243	Industrial and Commercial Bank of China	20,757	637,829	299	0.0	389,045	53,354	768
39	331	China Construction Bank	15,825	429,432	50	0.0	275,029	57,539	181
45	358	Bank of China	15,022	464,213	554	0.1	188,716	79,599	2,937
50	412	Agricultural Bank of China	13,303	359,632	232	0.1	511,425	26,012	454

Source: 2004 Global 500, *Fortune* July 26, 2004