Role of State in the Evolution and Success of Commercial Banks in China

Bhabani Shankar Nayak[1] & Yilin Gao[2]

[1] Coventry Business School, Coventry University, UK

[2] Adam Smith Business School, University of Glasgow, UK

Correspondence: Dr. Bhabani Shankar Nayak, Senior Lecturer in Business Strategy, Coventry Business School, Coventry University, UK.

Received: November 19, 2018 Accepted: December 11, 2018 Online Published: December 20, 2018

doi:10.5430/rwe.v9n2p38 URL: https://doi.org/10.5430/rwe.v9n2p38

Abstract

The article outlines the role of state in the evolution of commercial banks in China. It looks at different stages of its development process. The paper engages with the deepening of state led financial reforms which led to the competitive advantage of China's commercial banking industry. The state-owned commercial banks, large joint-stock commercial banks, and small private commercial banks keep increasing their strengths due to regulations and monitoring by the Chinese state. Therefore, the article argues that state-owned commercial banks have relatively large market share and dominate in commercial banking sector due to the state.

Keywords: commercial banks, state, China

1. Introduction

There was a mono-bank system prior to the 1978 reform in China. From 1948 to 1978, China implemented a planned economic system with advanced tactics for production materials and products. In the period when material data flow was limited, banks were not yet been able to carry out independent economic business. They were merely completing tasks the state and government money processing agencies distributing. At this stage, the People’s Bank of China controls the monetary funds in China as a whole (Berger et al., 2009). All financial businesses are also operated and managed by the People’s Bank of China, and there are few contacts with international financial institutions such as the International Monetary Fund and the Asian Development Bank. The aim of banks, which were part of the administration was ensuring the national production plans to be fulfilled. As a result, banks had no incentive to improve themselves to win the competition when competing with others (Jin and Zhang, 2009).

In December 1978, the People's Bank of China began to transform into the Central Bank of China, and gradually established a multi-level banking system such as a city commercial bank, a nationwide joint-stock bank, and a state-owned large-scale commercial bank, which were supervised and managed by the China Banking Regulatory Commission (CBRC, 2011). In October 1992, to further deepen reform and promote economic development, the state emphasised the gradual entry into the stage of the socialist market economy. At the end of 1993, the state promulgated relevant policies and regulations aimed at creating a unique professional commercial bank in China. Since then, China Development Bank, China Agricultural Development Bank and China Export-Import Bank have been established and listed. The establishment of the three major policy banks marks the formal separation of commercial banks from Chinese policies. Many joint-stock commercial banks immediately emerged including Hua Xia Bank, Pudong Bank, and Everbright Bank in China, when China carried out the transformation of the internal operating mechanisms of the four major state-owned commercial banks. The emergence of this batch of banks brought a new competitive landscape to commercial banks at that time, namely eliminating monopoly and promoting competition (Jiang, Yao and Zhang, 2009).

Following China's accession to the WTO in 2001, the financial industry faced the coexistence of opportunities and challenges in joining WTO development. In February 2002, the highest-level financial conference was convened. The meeting proposed to accelerate the comprehensive reform of state-owned commercial banks including abolishing the credit ceiling for deposits and loans, handling non-performing loans of state-owned commercial banks, and recapitalising state-owned commercial banks (Gao and Li, 2011). Banks are also encouraged to seek the listing on stock exchanges, introduce management incentives, and introduce foreign strategic investors. In addition, the meeting indicated that it is necessary to activate the National Commercial Bank, and under the premise of adequate supervision, appropriately reduce the control over commercial banks and encourage and assist competent commercial banks in reforming the modern enterprise system (Tong, 2005).

Since 2005, the China Banking Regulatory Commission has begun to convert state-owned banks to joint-stock companies by introducing overseas strategic investors and listing on stock exchanges. During the of recapitalisation, banks have achieved diversified ownership and are now operating as profitable commercial banks with less government intervention. Specifically, the market share of the five largest state-owned banks fell in the last decade, while the market share of other types of commercial banks like CCB, which have less state intervention and may have better corporate governance than state-owned banks, increased steadily (Ferry, 2009). By the end of December 2006, China has removed all geographical and customer restrictions on foreign banks according to the terms of the accession agreement. Foreign banks are no longer treated differently when competing with domestic banks, and there were 42 locally licensed foreign banks allowed to engage in local and foreign currency businesses with all types of customers at the end of 2013 (Dong, Firth, Hou, and Yang, 2016). By attracting foreign capital, foreign banks intensify competition in China’s banking industry and introduce advanced management techniques and expertise to promote the efficiency of Chinese banks (Luo, Dong, Armitage, and Hou, 2015).

The state-owned large-scale commercial banks are the pillar of China's economy. They have become real commercial banks in response to banking reforms, and have gradually become modern enterprises (Jiao and Zhang, 2009). The services of these banks are mainly provided for large-scale business units, which are significantly affected by the national policies. Joint-stock commercial banks, which play increasingly important roles in the market-oriented reform of China's commercial banks and in deepening the improvement of the financial system are mainly to assist the development of the entire commercial bank. The business of them is primarily to provide financial services for Sino-foreign joint ventures, private enterprises, individual smallholder economy. Moreover, domestic joint-stock commercial banks are also indispensable, which have a proper governance structure; also, the scale of joint-stock business is between large state-owned commercial banks and other commercial banks. Their customer orientation is mainly medium-sized enterprises, which can be penetrated by both sides, and there is an expansion capacity for future development (Yuan, 2014). As a representative of a different commercial bank, China City Commercial Bank as an integral part of China’s commercial bank was developed based on a cooperative city bank, and mainly supplements the development of the entire commercial bank. Guo and Liu (2012) highlighted that city commercial banks obeying the basic principles of commercial banks mainly serve private enterprises and promote the rapid development of local economies.

The sustainable development of city commercial banks therefore plays a vital role in supporting the reform of the financial system, the simplicity and convenience of SME loans, and the resolution of a regional financial crisis. Besides city commercial banks, joint-stock banks, and domestic large-scale commercial banks, there also exists other financial institutions including rural credit cooperatives, rural commercial banks, policy banks, foreign banks and so on (Wu, 2010). Other financial institutions have improved China’s financial organisational system and played an increasingly important role in advancing China’s economic transformation, technological transformation, optimising industrial structure, and increasing the added value of the industrial chain.

2. Lineages of State-Owned Commercial Banks in China

Following the establishment of the People's Bank of China from the financial sector in 1978, three state-owned professional banks, the Agricultural Bank of China, the Bank of China, and the Construction Bank of China, were separated from the Ministry of Finance and People’s Bank of China in 1979 (Chen and Zhen, 2011). Following the start of the urban reform, the People's Bank of China gradually withdrew from the market for commercial currency transactions and established a bank specialised in dealing with commercial currency transactions - the Industrial and Commercial Bank of China (Shang, 2000). The establishment of the Industrial and Commercial Bank of China has dramatically promoted the flow of social currency funds after the reform. Aiming at alleviating financial burdens and facilitating a rapid change of the stock market, the state once again divested the bad assets of the four major state-owned banks which are sold through market bidding to asset management companies. The introduction of overseas strategic investors has become a strategic choice for the reform of state-owned commercial stocks due to longer-term considerations. This not only changed management mechanism of state-owned commercial banks but enhanced their competitiveness (Lei, 2014).

After joining the WTO, the Chinese banking industry has also been fully open to foreign investment. At the end of 2003, the government proposed that the state encouraged and supported competent commercial banks to carry out recent enterprise reforms and create conditions for listing as soon as possible while improving the business level. At the same time, the CBRC introduced five principles for the introduction of foreign investors (Liu, 2014). However, for CCB, BOC, and ICBC, the work involved in entering foreign capital is exceptionally challenging when considering price, risk and low transparency of these banks.

In 2005, CCB successfully introduced two investors from Bank of America and Temasek Holdings Co., Ltd. In the same year, BOC introduced RBS, Temasek, UBS and Asian Development Bank as investors. In 2006, ICBC received foreign exchange capital injections from American Express and Germany Allianz; in the following year, the Bank of Communications became a member of the state-owned banks and formed the current “five major state-owned commercial banks” (Li, 2013). The completion of the financial restructuring, the introduction of overseas strategic investors, and the establishment of joint-stock limited companies, to some extent, solved the institutional problems which restricted the development of banks. To further adapt to the needs of China's domestic market economy, promote the reform of modern enterprises, and supervise the holding of shareholders of enterprises, it is necessary to reform the shares further and introduce non-state-owned capital (Ferry, 2009). The listing of state-owned commercial banks is the best way to achieve this goal. Bank of Communications among five state-owned commercial banks raising more than two billion dollars through the IPO in Hong Kong in 2005 is the first bank listed in stock exchange while CCB, BOC and ICBC issued their IPOs respectively in 2005 and 2006. With the listing of ABC in 2010 in Shanghai and Hong Kong Stock Exchanges, all the state-owned commercial banks finished their IPOs (Tan and Floros, 2014).

3. Competitiveness of State-Owned Commercial Banks in China

Although China’s state-owned commercial banks are commercially viable, they are still severely constrained when compared with commercial banks in foreign countries, mainly due to historical reasons and policy interventions. State-owned commercial banks are still supervised by the government whose financial flows are mostly distributed according to geographical and sectoral formulas, and they have little control over the cost base.

The state-owned commercial banks which still play the role of “financial supervisors” of state-owned enterprises and the large state-owned industrial sector are inextricably linked to maintaining the stability of national output, especially employment (Xu, Gan and Hu, 2013). Therefore, the Chinese government is always ready to rescue any failed state-owned commercial banks by capital injection and taking over bad assets. Based on this evidence, Chinese state-owned commercial banks are unique among the commercial bank industry. However, state-owned commercial banks have a relatively large market share and are therefore the dominance in the development of commercial banks (Fu and Heffernan, 2007).

There are several significant competitive advantages of China's state-owned commercial banks: firstly, they have relatively large assets; then their management fees are lower than those of foreign banks because of government control; thirdly, Chinese state-owned commercial banks have many branches based on substantially fixed customer base (Wang, 2010). Although the five major state-owned commercial banks are listed, the government still holds the major shares of these banks. As a consequence, Chinese people generally think that state-owned commercial banks are the most reliable (Qian, 2016).

Recently, China’s state-owned commercial banks have been working harder to improve their competitiveness with the emergence of other stock-joint commercial banks and foreign banks by paying more attention to intermediary business than to traditional companies. The state-owned commercial banks are facing more and more customer groups whose basic needs are getting higher and higher. Kong (2007) found that the traditional product types and management models of state-owned commercial banks can no longer meet the needs of the general customers which require state-owned commercial banks to carry out reforms and innovations. Due to the small number of intermediate businesses of state-owned commercial banks in China, there is still a significant gap compared with foreign advanced state-owned commercial banks. At present, there are more than 3,000 intermediary services (Berger A, 1995) issued by the World Bank, and there are only about 300 kinds of intermediary business (Hu, 2007) in China. According to the survey, the proportion of the intermediary business income of major state-owned commercial banks in the developed western economies led by the United States is around 50% (Huizinga, 2000).

In contrast, the proportion of the non-interest income of state-owned commercial banks in China is relatively small although it has been dramatically improved. To be specific, by the end of 2016, Bank of China had the highest non-interest income share of 36.72% while Agricultural Bank of China only accounted for 21.33% of non-interest income which was lowest among five state-owned commercial banks (Cao and Ding, 2018). Among them, the proportion of the non-interest income of the Bank of Communications has improved the fastest from 18.47% to 30.17%. However, the operating revenues of the five state-owned commercial banks in the past five years are still dominated by interest income (Liu, 2015), and the proportion of non-interest income to operating revenue is not high comparing with foreign commercial banks.

It is necessary to change the unfavorable situation such as a single profit model and narrow investment channels as soon as possible before the interest rate market are fully opened.

In comparison with foreign banks, China's state-owned commercial banks still have insufficient competitiveness (Yang, 2009). Although the financial indicators of Chinese state-owned commercial banks have gradually approached to international level and been improved more than before, financial indicators do not adequately reflect the current state of competition. In contrast, some survival factors like competition strategy, marketing ability and customer demand which are rarely involved in ranking do determine the long-term competitiveness of commercial banks (Song, 2005). For example, service quality problems including poor service attitude, lack of business expansion capacity and inefficient working process do exist in China's state-owned commercial bank causing them less competitive than foreign commercial banks.

According to the result of “Research report of Chinese and foreign commercial banks competitiveness in Beijing” which based on five indicators: external environment, operation condition, business development capacity, product innovation and organizational management, the indicators of all foreign banks rank higher than China’s commercial banks (Jin and Zhang, 2001). This result surmises that the competitiveness of China's state-owned commercial banks is not as optimistic as one might think. China's state-owned commercial banks do have some problems with service quality and inefficient workflow processes. Although the customer base of China's state-owned commercial banks is relatively stable, if financial innovation and service quality are not improved, existing and potential customers might be transferred to foreign banks. Additionally, the financial products of state-owned commercial banks have not established a right brand image, and the brand image of them remains in the memory of history. For example, when people talk about China Construction Bank, they first think that their financial products are related to construction investment (Xu, Gan and Hu, 2015).

Although joint-stock banks and foreign-funded banks are thought to be more efficient than the state-owned banks in some aspect, state-owned commercial banks still dominate the market under the protection of the Chinese government and gain monopoly profits (Huang, Li and Zhao, 2014). Moreover, Yao et al. (2008) found that the efficiency of the state-owned banks is not necessarily lower than that of joint-stock banks. There is substantial evidence that Bank of China is one of the best performing commercial banks in China. Besides, the Bank of China and Industrial and Commercial Bank of China as the representatives of state-owned commercial banks have dominated the market with high-tech efficiency and profitability (Hao, 2006).

4. Conclusion

The market structure of China's commercial banking industry is monopolistic competitive market structure. According to the basic principles of western economic theories, monopolistic enterprises should have monopolistic profits. Specifically, companies that are in a monopolistic position will generate higher earnings than those competing in the general competitive structure of the entire market (Andrijauskas, Jasienė and Staroselskaja, 2014).

However, the market power of state-owned banks, which occupies a large market share and institutional network advantage, does not have the benefit of the monopoly, even worse its performance is generally worse than that of general joint-stock commercial banks. The reason why state-owned commercial banks have market monopoly power without monopoly performance is that China has come from the planned economy to the market economy reform. Before 1993, China's state-owned commercial banks operated not according to the laws of the market economy but governed the construction of social funds under the leadership of governments at all levels. This resulted in a considerable amount of non-quantity assets that affected the competitiveness of state-owned commercial banks (Qian, 2016).

After the financial restructuring and shareholding system reform, the major state-owned banks have undergone vast changes in corporate governance and business philosophy. A qualitative leap has taken place in the areas of capital strength, risk management, and profitable business structure. The gap with the top ten international banks is gradually narrowing, and some indicators have even surpassed. The major state-owned banks have primarily withstood the test of the financial crisis in the past two years, their international influence has been significantly enhanced, and their international status and global competitiveness have increased rapidly (Song, 2005).

Qualitative trends in the improvement of the overall competitiveness of the state-owned banks in China can be obtained based on existing theories. However, it cannot quantitatively reflect the specific competitiveness of them. Hence, a further quantitative empirical analysis is needed to explore the detailed changes in the overall level of competitiveness.

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