WTO, Banking Sector Openness, and Risk Management

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I. China’s commitment to open the banking sector
II. Why open the banking sector? Benefit and risk in opening banking sector and international experience
III. China’s banking sector: what is likely to happen?
IV. Risk management in general: beyond banking: macro-micro
I. China’s commitment is strong and ambitious in opening its banking sector

China has committed to open its banking sector to foreign banks after joining WTO:

• Immediately open foreign currency business to foreign banks without limit;

• In the 2nd year, open RMB business to firms, and open four cities each year; and

• In the 5th year, open RMB business to all residents in all regions with no geographic limit.

• Open to non-bank FI on car loans, other information and financial/consulting services.

See Annex 9 of China’s WTO agreement.
## China’s commitment: geographic restrictions

<table>
<thead>
<tr>
<th>Time after joining WTO</th>
<th>Geographic Restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange</td>
<td>No geographic restriction</td>
</tr>
<tr>
<td>On RMB business:</td>
<td>Open Shanghai, Shenzhen, Tianjin, Dalian, immediately</td>
</tr>
<tr>
<td>1 year after joining</td>
<td>Open Guangzhou, Zhuhai, Qingdao, Nanjin, Wuhan;</td>
</tr>
<tr>
<td>2 years after joining</td>
<td>Open Jinan, Fuzhou, Chengdu, Chongqing;</td>
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<td>3 years after joining</td>
<td>Open Kunming, Beijing, Xiamen</td>
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<td>4 years after joining</td>
<td>Open Shantou, Ningbo, Shenyang, Xi’An</td>
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<tr>
<td>5 years after joining</td>
<td>No geographic restriction</td>
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</table>
II. Why Open? International experience

• Financial development contributes significantly to growth, through efficient allocation of resources (King and Levine 1993, and Leving and Zervos 1998)

• Financial markets reduce the information cost of borrowing and lending and help allocate risks

• Financial assets (with attractive returns) encourage saving in financial form

• Financial institutions, banks, mutual/pension funds and others, play important roles in efficient resource allocation

• An efficient banking system requires a contestable system—one that is open to entry and exit
Foreign bank presence has sharply increased in the developing countries (percent)

Source: World Bank staff estimates in Global Development Finance 2002; Bankscope
Benefit of banking sector openness:

The presence of foreign banks

- is associated with higher efficiency of banking system, which would improve the allocation of resource and is growth-enhancing.
- It may reduce financial intermediation costs as reflected in domestic banks’ lower net margins, non interest income and lower overhead costs.
- It reduces domestic banks’ pre-tax profitability in high-foreign-entry market
- It helps enhance the capacity of domestic banks by training staff that then move to domestic banks.

Risks associated with foreign bank entry

- If foreign banks capture the most profitable segments of the market, leaving domestic banks more exposed to the less profitable segments, domestic banks may have an incentive to take on greater risks (Hellmann, Murdock and Stiglitz 2000).
- In the short or medium run, domestic banks may lose some high quality customers and suffer losses in their profit margins.
- In addition, domestic banks may engage in more strict credit rationing—limiting the access to credit by the poor (Agénor, 2001, World Bank 2002).
The case of Singapore: Macro policies and risk management through building assets

- Singapore’s prudential fiscal policy encouraged high saving and investment
- Monetary policy was centered on exchange rate
- “The development of Singapore’s financial sector was gradual, carefully controlled, guided by conservative prudential practices, and strict government regulations.” (IMF 2000)

⇒ Rapid accumulation of physical capital; structural transformation, and diversification of Assets
Foreign Bank’s presence is favorable for Financial development and risk mgmt
Equity Market Development: Market cap over 100% of GDP: Size Matters

Stock Market Capitalization % of GDP

Source: Author
### III. China: The private sector is the engine of growth and largest employer but not the largest investor: Why?

<table>
<thead>
<tr>
<th></th>
<th>State</th>
<th></th>
<th></th>
<th></th>
<th>Collective</th>
<th></th>
<th></th>
<th></th>
<th>Other</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>47.7</td>
<td>35.9</td>
<td>..</td>
<td>18.5</td>
<td>20.5</td>
<td>..</td>
<td></td>
<td></td>
<td>33.7</td>
<td>43.4</td>
<td>..</td>
<td></td>
</tr>
<tr>
<td>Urban Employment</td>
<td>62.3</td>
<td>43.8</td>
<td>35.0</td>
<td>21.4</td>
<td>9.5</td>
<td>6.5</td>
<td></td>
<td></td>
<td>16.3</td>
<td>46.7</td>
<td>58.5</td>
<td></td>
</tr>
<tr>
<td>Investment in fixed assets</td>
<td>66.1</td>
<td>54.1</td>
<td>50.1</td>
<td>11.7</td>
<td>14.8</td>
<td>14.6</td>
<td></td>
<td></td>
<td>22.2</td>
<td>31.1</td>
<td>35.3</td>
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</table>

Source: CICC
China’s banking sector is dominated by four State-owned banks which have been providing financing to the SOEs and running inefficiently.

They have extensive branch networks and employ 1.7 million people.

But they are actually bankrupt. The total amount of Non-performing loans were estimated at 25.4% (Dai, 2002) to 40% of their total assets. “In NPL, 600bn yuan was actually lost, accounting for 8% of total loans (Dai, 2002)” which will wipe out the entire capital...

Four AMCs were established to restructure the NPLs. Fiscal revenues were injected to recapitalize the banks. However, bad loans continue to grow. This will add to the contingent liabilities of the government.
Loans to non-state sector were low, hindering the development of small and medium non-state enterprises (SME)

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<tbody>
<tr>
<td>Proportion of loans to non-state sector in total loans by all banks (%)</td>
<td>8.76</td>
<td>12.38</td>
<td>12.83</td>
<td>14.24</td>
</tr>
<tr>
<td>Proportion of loans to non-state sector in total loans by State owned Banks (%)</td>
<td>7.16</td>
<td>7.98</td>
<td>8.10</td>
<td>8.85</td>
</tr>
</tbody>
</table>

China’s Openness in Financial Sector: Slow and Cautious

- Banking sector: By end-’01, over 200 foreign banks/branches and foreign finance companies were allowed to operate only in a few cities.
- Total assets of foreign banks were ~2% of all assets in financial sector, but their credits accounted for 30% of foreign exchange credits.
- Equity market grew rapidly. By end-2001, over 1100 publicly listed companies were listed on domestic stock market (A shares). Total market capitalization reached nearly 50% of GDP. But the markets are fragmented by A shares and B shares.
- Insurance sector: next speaker
# Challenges to China’s inefficient banking sector

<table>
<thead>
<tr>
<th>Banks</th>
<th>Tier-1 capital $mn</th>
<th>Returns on assets %</th>
<th>Profit/employee ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citi-Group</td>
<td>54,498</td>
<td>2.34</td>
<td>91,930</td>
</tr>
<tr>
<td>HSBC</td>
<td>34,620</td>
<td>1.43</td>
<td>59,560</td>
</tr>
<tr>
<td>ICBC</td>
<td>22,792</td>
<td>0.13</td>
<td>1,340</td>
</tr>
<tr>
<td>AgriBC</td>
<td>15,971</td>
<td>0.01</td>
<td>210*</td>
</tr>
<tr>
<td>Bank of China</td>
<td>17,086</td>
<td>0.22</td>
<td>4,070</td>
</tr>
<tr>
<td>ConBC</td>
<td>13,875</td>
<td>0.34</td>
<td>3,190</td>
</tr>
</tbody>
</table>

What is likely to happen after joining WTO in the opening cities?

• Domestic banks may lose high-quality customers. E.g. Ericsson Nanjing has reportedly shifted its main business account from a Chinese bank to Citibank in Shanghai.

• Domestic banks may lose high-quality managerial talents to foreign banks

• Domestic banks may engage in credit rationing, retreating from loss-making regions such as the rural and western regions. e.g. branch consolidation

• Domestic banks may engage in more risk taking……
In 5 years China may no longer be insulated from financial volatility

- Foreign banks/institutions operating in China are confronted with global volatility
- Domestic banks/institutions may take more risks, and diversify to international market
- Domestic firms may borrow from foreign banks, and take risky positions—the overborrowing syndrome may occur
- Opening financial services does not mean opening capital account. But the capital account control may under pressure and may have to be gradually lifted
- Thus, more reform, better regulation and supervision are needed.
Capital flows are volatile. Risks must be carefully managed.

Sources: IMF World Economic Outlook October 2001
Volatility hurts the poor most: Risk management is crucial

IV. Risk management in general: A framework

• The valuable assets for development include at least human, physical/financial, and natural capital. Building and diversifying assets are crucial to risk management.

• Investors view a nation’s asset as collateral against default risks. If a nation lacks these assets that are crucial for development, it cannot attract foreign investment, and it lacks ability of reducing risk through diversification.

• Poor countries lack some of these assets that are crucial for development, and they are vulnerable to risks and volatility.
A Framework

- Providing sound macro policy
- Strengthening regulation
- Risk management via building assets
- Correcting market failures hurting H and R
- Good governance to ensure policy consistency

Asset and Liability Analysis

**Assets**
- Human capital
  - local workforce
  - Foreign talents
- Physical/financial capital
  - Industrial infrastructure
  - Savings and CPF
  - Foreign reserves
  - External assets
- Natural capital (net)

**Liabilities**
- Explicit and direct
  - Sovereign debt
  - other debt
  - currency in circulation
- Contingent liabilities
  - Non performing Loans?
  - Guarantees?
- Implicit liabilities
  - Implicit pension debt?
Financial Market Deepening may help to reduce the volatility and risks.

Liquid Assets as a share of GDP

Source: Author
General Policy options to manage risks associated with financial integration

WB’s CEM 2002 proposes three pillars of risk management: accumulating assets, building institutions, and government policies:

• Implement Prudential fiscal policy to encourage saving and investment
• Reduce guarantees and contingent/implicit liabilities
• Enhance the fiscal transfers to the poor
• Invest in the human capital of the poor
• Provide social safety net
Proposed Strategies in banking and financial areas

• Speed up the restructuring of the state banking sector; diversify the ownership and allow them to be publicly listed on the stock market.

• Allow more rapid development of nonstate / shareholding banks/ financial institutions to meet the needs of private sector development

• Strengthen the financial regulation and supervision systems

• Gradually liberalize interest rates and allow more flexible exchange rates.
GATS encourages prudential regulations

• “Members shall not be prevented from taking measures for prudential reasons…” Thus, GATS negotiations focus on getting better performance, while allowing for improved prudential regulations. [Annex of GATS]

• To reduce capital flow volatility, a spectrum of capital flow interventions can be implemented even after strict capital control is lifted……
Macro-Policy Options: A Spectrum of Capital Flow Interventions

1. Financial Autarky
2. Quantity Controls (All Capital Inflows)
3. Tax/Non-Remunerated Reserve Requirement (All Capital Inflows)
4. Quantity Control on “Risky” Inflows
5. Tax on “Risky” Inflow (e.g. Chile)
6. Remunerated Liquidity Requirements
7. Purchase Insurance (e.g.: Contingent Liquidity Facility)
8. Other Risk Management Techniques (Asset/Liability Mgmt, e.g. Singapore)
9. No Intervention

Increasingly Severe Intervention: Reduction in Benefits of Foreign Capital & Reduction in Risks

Self-Insurance
Risk Management
Change Inflow Composition
Reduce Capital Inflows

Nth. Best World
1st. Best World

Source: Revised based on Powell, On Liquidity Requirements, Capital Controls and Risk Management: Some Theoretical Considerations and Practice from the Argentine Banking Sector, 1999
Summary

- Opening banking sector will improve efficiency and benefit China’s growth in the long run, especially considering China’s large amount of savings
- but mid-term risks cannot be ignored
- Capital flows are volatile in nature, and volatility hurts the poor most—rationale for public policy
- Building up assets is important for risk diversification
- Tight fiscal discipline encourages saving and investment
- Strengthening financial regulation and supervision, including capital flow interventions, is crucial
- Financial risks/bad loans can become a heavy burden on fiscal budget
Which way to go?

• If structural problems can be solved, domestic banks actually have many advantages.

• In Australia, the domestic banks took liberalization seriously, improved their efficiency, and beat out the foreign banks.

• In Latin American countries, local banks were wiped out.

• Which way will Chinese banks go?