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The Chinese Banking System (Part 3)

Going to a Chinese bank to open a bank account has always been an adventure. The first time you walk in assuming you have all the necessary documents and plan on being finished within 15 minutes, only to find out you actually need some more documents after waiting an hour on a small, uncomfortable bench. But

what system is behind these banks and do they all operate in the same way? You will find out in this article.

The Chinese banking system is characterized by several different tiers of banks. The most famous are the Big Four; Bank of China (BOC), the China Construction Bank (CCB), the Agricultural Bank of China (ABC), and the Industrial and Commercial Bank of China (ICBC). In 1995 the government passed the Commercial Bank Law to commercialize the operations of these four state-owned banks. Smaller commercials banks are the second tier commercial banks like China Merchants Bank. These banks generally have healthier balance sheets and higher profitability because the state doesn't dictate their lending business. Finally there are the city commercial banks like Bank of Ningbo and the small rural banks.

The traditional Chinese banking system was characterized by a ceiling for deposit rates and a floor for bank lending rates. These rates, set by the People's Bank of China (PBOC), ensured that Chinese banks were able to make substantial profits to cover losses on non-performing loans. According to a report of the central bank in 2002, non-performing loans (i.e. loans that are likely to default) accounted for 21.4% to 26.1% of the total lending of China's four big banks. Several asset management companies were formed to transfer the loans off the balance sheets of the banks and repackage them into viable assets that could be sold to investors. After many highly profitable years for the banks, the PBOC decided to slowly relax the ceiling and floor and recently decided to completely end the deposit and lending rate controls. The current long-term deposit benchmark rate at Chinese banks is 2.75%, while the lending rate is 4.35%. This flexibility will create more competition between traditional banks and online banks to attract deposits at attractive rates.

In 2008-2009 China encountered on a bank lending stimulus program in the hope it would spur economic growth. Non-financial debt (debt held by households, local governments, and companies outside of the financial sector) has risen from 100% of GDP to 250% of GDP and the speed of credit creation is still accelerating. Most of this lending is provided by banks, although shadow banking is also very common in China. All this credit creation has resulted in more and more non-performing loans, which can lead to defaults. This makes banks suspicious of lending to each other because it is hard to determine how many bad loans the other bank has on its balance sheet. This has caused the interbank rates to fluctuate drastically. The interbank rate is the rate that banks charge each other for short-term loans.

Analysts say soaring interbank rates are a sign of stress in the banking system, which means banks or financial institutions could default, leading to big losses. In the previous article we mentioned that the 'web-banks' invest in the interbank market, with the possibility of high returns but also the possibility of default. The central bank of China, the PBOC, still has a firm grip on the banking sector. A banking crisis is something they certainly want to avoid, and they have many policy tools to make sure this does not occur. Therefore bank defaults are not very likely in China at this point in time, although there certainly are risked attached to the smallest, rural banks. Most of the deposits of the 'web-banks' are with banks other than the 'Big-Four', because these state-owned banks do not trade with them in the interbank market as they see the web-banks as competition.