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**What can China's SOB's learn from its competitors?**

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## **Abstract**

With the liberalization of its financial system and accession into the World Trade Organization (WTO), China's commercial banks face unprecedented challenges and opportunities. As the representative of joint-venture banks, China CITIC bank has been listed on both the Shanghai and Hong Kong stock exchanges and has achieved substantial success during the last 20 years. At the end of 2006, according to the calculations of the British magazine "The Banker", this bank was ranked the 134<sup>th</sup> largest bank in the world in terms of total assets (Jiao, 2007,p135). Using a case study of China CITIC bank's successful experience, this paper will examine the current problems and challenges of state-owned banks (SOB's) and joint-venture banks to find out(1)how much can SOB's learn from CITIC's experience;(2) what is the limitations for SOB's in imitating CITIC's case model; (3)what needs be done to improve SOB's inherent problems? To answer the questions above, this paper will select some of CITIC bank's successful strategies that can be adopted by SOB's and match it with SOB's inherent characters to answer the limitation of this case study and to give recommendations for SOB's further development.

**Key words: SOB, China CITIC bank, case study**

## List of Abbreviations

<b>ABOC</b>	<b>Agriculture Bank Of China</b>
<b>ADBOC</b>	<b>Agriculture Development Bank of China</b>
<b>ATM</b>	<b>Automatic Teller Machine</b>
<b>BOC</b>	<b>Bank of China</b>
<b>BOCOM</b>	<b>Bank of Communication</b>
<b>CBRC</b>	<b>China Banking Regulatory Commission</b>
<b>CDB</b>	<b>China Development Bank</b>
<b>EC</b>	<b>European Community</b>
<b>ICBC</b>	<b>Industrial and Commercial Bank of China</b>
<b>IEBOC</b>	<b>Import and Export Bank of China</b>
<b>NPL</b>	<b>Non Performance Loan</b>
<b>PBOC</b>	<b>People's Bank of China</b>
<b>PCBC</b>	<b>People's Construction Bank of China</b>
<b>RMB</b>	<b>Ren Min Bi</b>
<b>R&amp;D</b>	<b>Research and Development</b>
<b>SOB</b>	<b>State-Owned Bank</b>
<b>SOE</b>	<b>State-owned Enterprise</b>
<b>VIP</b>	<b>Very Important Person</b>

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## **1. Introduction**

### **1.1. Background**

The Chinese economy has experienced rapid growth since the implementation of the open door policy. At the same time, the banking sector has endured huge structural changes and reforms. Despite the significant changes and reforms in the last 30 years, the banking system still has problems such as low efficiency and mounting non-performing loans, which make further reforms increasingly difficult (Yao et al, 2007,p629).The inherent structural problems of a planned economy, to a large extent, encumber the development of China's banking sector.

At present, state-owned banks continue to dominate China's financial system and they are still the main channels of financing for business companies. By the end of 2002, the total assets of the banking sector were 26.4 trillion yuan accounting for 85 percent of the total assets of the entire financial sector (Luo,2003,p2). The Chinese banking system comprises several institutions including state-owned banks, joint-venture banks, city-commercial banks, urban credit cooperatives, postal savings bank etc. However, four large state-owned banks still dominate China's banking system, which account for 61 percent of the loans (Luo,2003,p2).

Along with the deepening of China's economic reforms, China's banking system faces more austere challenges. Gradually opening financial markets result in increased competition for Chinese domestic banks. According to the World Trade Organization (WTO) agreement, China has to remove all of the restrictions pertaining geography and business scope to the foreign banks and completely open the banking system within five years of WTO accession. WTO accession makes Chinese domestic banks face both unprecedented opportunities and challenges. How do these banks respond to these opportunities and challenges and how do they use their own advantages to be successful in the new financial environment, are the key questions for the Chinese commercial banks currently.

## **1.2. Aim**

In this paper, I will use China CITIC bank, which is a good representative of joint-venture banks, as a case study to analyze the problems and challenges of Chinese commercial banks face today and try to investigate whether CITIC bank's successful experience is suitable for state-owned banks' further development. This study intends to answer the three following questions:

- (1) How much can SOB's (state owned banks) learn from CITIC bank's experience?
- (2) What is the limitation for SOB's to imitate from this case?
- (3) What needs to be done to solve SOB's inherent problems?

## **1.3. Methodology**

In order to answer the questions above, I used as my primary and secondary sources through comprehensive methods. My primary sources were obtained by interviewing the International Settlement Manager of China CITIC Bank (Wenzhou branch) and through an interview with one of the staff members in China Banking Regulatory Commission (CBRC) Shanghai branch by phone. The secondary sources came from China CITIC bank's annual report, balance sheet, CBRC's annual report SOB's and other information is from China CITIC bank's website and China's financial year book.

## **1.4. Limitations**

Due to the fact that SOB's have their inherent characters and problems such as government intervention, soft budget constraint and multiple objectives, SOB's couldn't adopt some of CITIC bank's strategies. Therefore, from this case, it can't provide overall development direction for SOB's reform but at best provide a general sense of direction. In addition, the latest annual report of CITIC bank that was obtainable was from 2005, so some figures and market strategies and policies will be dated.

## **1.5 Outline**

This paper is divided into five parts. The first part contains the introduction, in which I summarize the general background of the Chinese banking system, explain the challenges and problems for the Chinese commercial banks and explain the aim, methodology and limitation of this paper. The second part is the theoretical framework where I use two broader views: “development” view and “political” view to compare the different views about ownership of banks and describe the different characters of state-owned and non state-owned banks. I review the development of Chinese banking system after 1978, which includes banking reform, WTO regulations, current Chinese banking system, performance and the challenges of China’s commercial banks. In part three, I delve into the China CITIC<sup>1</sup> bank as a case study, describe the development, performance and business strategies of CITIC bank to find what state banks can learn from this case, the limitation of this case and the suggestion for SOB’s further reforms. Part four is my conclusion, which answers the questions raised at the beginning of this paper and draw the conclusion of this study. A complete list of references used in this study can be found in part five.

## **2. Theoretical Framework**

Financial development is the key factor that affects the economic growth in countries. Good financial environment and a sound financial system, to a large extent, accelerate growth of an entire economy. Large numbers of theoretical and empirical studies have found positive correlation between financial development and economic growth.

Koivu (2002) and Levine (2002) found “financial development can accelerate economic growth by affecting the savings rate by channeling saving to investments or by improving the productivity of investments. Levine, in particular, finds that financial development complemented by enforcement of legal rights of outside investors, and an efficient legal system, contributes to long-run economic growth” (Foo,2005,p3). In addition, Bencivenga and Smithe (1990)found that financial

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<sup>1</sup> CITIC: China International Trust and Investment Company

development promote capital investment and decrease premature liquidation. Their findings further prove the common assertion in the development literature that development of financial intermediation will increase real growth rates.

As the most important part of the financial system, banks play a central role in financing a transition economy. Numerous former studies have found the relationship between banking ownership and economic growth. After bank privatization had been completed in many countries, SOB's still accounted for a large proportion of banking around the world. Even looking at 1995 data, we find that the world average of government ownership is 41.6% (median 33.4%), and a somewhat lower 38.5% (median 30%) if we exclude the former socialist countries. The corresponding number for 1970 ownership is higher at 58.9% (median 57.1%) and 52.7% respectively. Comparing the numbers in these two years, we find that even though the proportion of state owned banks decreases sharply, government ownership of banks is still far from eliminated (La Porta et al ,2002,p11). La Porta et al.(2002)in their article summarized two broader views about state-owned banks, one is the "development" view which is inconsistent with Alexander Gerschenkron's (1962) view, which argues that privately owned banks play the crucial role in transferring savings into industry in several industrializing countries in the late 19th century. However, in some countries, economic institutions were not sufficiently developed (for instance scarcity of capital, low standards of honesty in business, less development of financial system) for private banks to play crucial effect in financial system. So in such countries whose financial system is underdeveloped, such as Russia, the government steps in and uses the financial system to accelerate both financial and economic development (La Porta et al,2002,p1). DincSerdar (2005) advocates the "development" view of SOB's in claiming it will facilitate some special projects which private banks are unable and unwilling to finance to accelerate economic growth. Gerschenkron (1966) argued that state owned banks contributed to the economic growth in countries that were relatively backward (Arun and Turner,2001,p90). Indeed, in the early stages of

development government ownership of banking may be necessary and useful to overcome the deficiencies of the financial system, and hence, bring an economy out of economic backwardness (Gerschenkron 1996, Arun and Turner, 2001, p92).

The other view, which is mentioned in the La Porta et al. (2002) article, is the “political view”. In this view, authors generalize some scholars’ (see, e.g., Kornai (1979), and Shleifer and Vishny (1994)) “political” view and point out that the purpose for governments participation in banks and enterprises is to provide employment, subsidies and other benefits to supporters who return the favor in terms of votes, political contribution and bribes. This attraction of political participation is greatest in underdeveloped financial systems and poorly protected property rights. Conceivably, in a developed market economy, state ownership of firms such as state owned banks may not help increase government revenue, and comparing with private ownership, the inefficiency associated with public ownership is likely to decrease profits and government revenue (Jin and Qian, 1998, p784). In addition, according to the study of Li (2008) and Xia (2008), they found that both state interference and agency problems in SOB’s negatively affect firm performance. On the other hand, they found that non-SOB’s are driven by market competition and achieve high profitability (Li and Xia, 2007, p51). Furthermore, those who advocate the “political” view argue that the costs of state-owned banks came to be seen as outweighing the benefits. Many of the costs and drawbacks of state-owned banks stemmed not only from the political influence but also from the conflict between the mandate for commercial viability as well as social and development objectives (Mohieldin and Nasr; 2005, p708). Mohieldin (2005) and Nasr (2005) further argue that, due to government participation, state owned banks base their loan decisions on political reasons so their profits are quite lower and lacking the ability to generate capital through retained earnings. Therefore, state-owned banks are more vulnerable during macroeconomic shocks. Finally, state owned banks also lead to misallocation of capital within the economy and the distortions it introduces make the financial sector

less able to contribute to growth (World Bank1989; Mohieldin and Nasr 2005,p708).

In comparing these two views, La Porta et al. (2002) conclude that both the “development” and “political” views imply that government ownership of banks is more prevalent in poor countries with less developed financial systems and institutions. But the development view emphasizes that the positive correlation between government ownership and financial, economic development, factor accumulation, and productivity growth. In contrast, the political theories imply that the intervention of government in financial system lead to adverse effect on productivity growth. La Porta et al. (2002) use data on government ownership of banks from 92 countries around the world and after regression tests, achieved results that are overall more favorable to the political view. They examine the relationship between state ownership and financial system, productivity growth and property rights and find that even in the 90’s the state ownership of bank still accounted for a large portion of global banking. In an average country, 59 percent of the 10 largest banks were stated owned in 1970 as well as 42 percent in 1995 which means in average the state still controls or at least has a major role in the financial system in most countries (La Porta et al,2002,p4). Furthermore, higher government ownership is generally associated with low levels of per capita income, underdeveloped financial systems, interventionist and inefficient governments, as well as poor protection of property rights. In 1970 government ownership of bank was associated with slower subsequent development in financial system. Finally, the regression results show that government ownership of bank is associated with lower growth of per capita income, and productivity growth rather than slower factor accumulation (La Porta et al,2002,p25).

### **2.1.State Owned and Non State Owned Banks**

The theoretical framework above examines the relationship between state-owned banks and different economic factors such as economic growth, financial system and property rights. In order to know the characteristics of state owned and private banks

in the transitional economy, I will compare the different characteristics of the state-owned and non-state owned banks in many aspects. In the government's view, the advantage of owning banks is that it enables the government to collect savings and to direct them toward strategic long-term projects. In this method, the government is able to work around institutional failures while further weakening private capital markets, aggregate demand and other growth factors (La Porta et al,2002,p3). According to the view of Shlefer and Vishny (1994)about public enterprise, we can conclude that state owned banks are more inefficient because of political pressures. State owned banks lack the independence needed to properly allocate credit. The government strongly influences these banks' loan decisions in order to achieve their own political or economic purpose. Most of their lending is not commercial lending but political lending. As one type of state-owned enterprise (SOE's), the SOB's are endowed with special functions that are divergent from typical commercial banks. In the transition economy, the main objective of the state owned bank is to facilitate the implementation of the government's physical plan (Chai,1998, Laurenceson and Chai,2001,p212). In this context, their performance errs from the main purpose of commercial banking, maximizing the profitable and reducing the lending risk. For the state owned bank, their performance is measured by how well they undertake the task of catering government purposes (Laurenceson and Chai, 2001, p213). Due to the objective and behavior of the state owned bank and its divergence from commercial banking in transition economies, as Laurenceson and Chai (2001), especially in China, the state owned banks are more akin to a development bank. The development bank's central purpose is "acceptance of responsibility for furthering the nation's development policies is the special factor that makes a bank a development bank. Whatever its name, the responsibility makes a conventional financial institution a development finance institution" (Diamond and Raghaven, 1982; Laurenceson and Chai,2001,p214). For the typical commercial banks the objectives of non-state owned banks are totally different. The behavior of the commercial bank is dictated by fundamental optimization, that is, to maximize the profits and be subjected to a risk

constraint (Santeromo, 1984; Laurenceson and Chai, 2001,p211). This means that as commercial banks, they will choose the project that will offer the highest expected rate of financial return. The only purpose to allocate the loans is to maximize profit and minimize risk.

Furthermore, comparing with non-state banks, SOB's face the softer budget constraints. State banks in transitional economies face soft budget constraints and have low incentives to improve their management and enhance their ability of competition. In contrast, the non-state banks face harder budget constraints. They have to enhance their competitiveness and have more incentive to innovate such as providing new financial products and service to attract new clients.

Literature on the subject has found a relationship between ownership and efficiency. According to the study of Yao al et al (2007), they found that ownership reform and change of budgetary constraints lead to more competition and hence greater efficiency gains. Their regression result shows that joint-venture banks outperform state owned banks by 18% in profitability and 8% in loans. The empirical research also suggests that banks, which face hard budget constraints and hence less capitalized, tend to take more risks and more efficient than those which face softer budget constraint (Yao et al, 2007,p641).

**Table 1: Comparison of State verses Non-State Banks**

	State banks	Non state banks
Softer budget constraints	Softer budget constraints	Harder budget constraints
Government intervention	Strong	Not Strong
Objective	Political and economic development	Maximize profit; reduce the risk
Efficiency	Less Efficient	More Efficient

## **2.2. Development of Chinese Banking Sector**

### **2.2.1. Chinese Banking System after 1978**

Before 1978, the Chinese banking system was completely controlled by the Chinese government. In this mono-bank system, the People's Bank of China (PBOC) combined two roles -- central and commercial banking. "The whole banking industry was regulated by strict cash and credit plans that were set in accordance with the production laid down by the State Planning Commission" (Wong Y.C. and Wong M.L.,2001,p19-20). Banks acted as if part of the administrative hierarchy, carry out their political purpose and ensuring the national production plans were financed. Between 1979 and 1984, four specialized banks were separated from the PBOC. At that time, the PBOC continued to play their role as the central bank, while the other four provided services for different appointed sectors. The major functions of PBOC include controlling the money supply, regulating the interest rates and directing the flows of money and credit in the economy through monetary policies. In addition, the PBOC also manages the country's foreign exchange reserves and represents the Chinese government in international monetary organizations (Tam,1986, p431). As the central bank, PBOC is endowed with the responsibility of supervising and giving the general policies to the four state banks and establishing financial policies to sustain stability and accelerate the development of financial markets. Even though these four banks have to obey the guidance and policy of the central bank, as commercial banks, they still have their own tasks in different areas. The main tasks of Bank of China (BOC) included attracting foreign exchange as deposits, providing finance through foreign exchange and dealing with international settlement. People's Construction Bank of China (PCBC) original purpose was to engaged in providing funds for construction from the state budget through the ministry of finance. The Industrial and Commercial bank of China (ICBC) provided the financing for commercial and industrial activities in urban areas and the Agriculture Bank of China (ABOC) engaged in appropriating funds the development of rural areas in terms of attracting deposits and providing loans in rural areas. In 1985, the four banks were

allowed to expand their scope of business; this was the first time they were allowed to break the strict limitation of their functions. Henceforth, banks began to compete with one another. Initially, competition amongst them was very limited. From the mid-1980's to mid 1990's, most of their lending was in support of government policy and they faced soft budget constraints which encumbered competition between one another. After the financial reforms of 1994, the competition between the four state banks gradually increased. Three policy banks-The Export-Import Bank of China, China development Bank and Agricultural Development Bank of China were established to replace the four banks assisting Chinese government in sustaining the economic development. The four state banks formally became commercial banks. The purpose of the policy banks is to handle policy lending in assisting the plans of the government in implementation. The three policy banks, to some extent, reduced the policy lending of the four state banks. Each of these policy banks has their own function for providing credit for different sections. The state development bank provides the loans for capital investment projects and physical infrastructure, the agricultural development bank supports the agricultural development while the Export-Import bank provide trade credit, export insurance, and working capital loans to export-oriented technological enterprises (Saez,2004,p21). However, because the policy banks lacked sufficient branch networks and capital to support policy lending the state banks' lending decision is still affected by central and local governments. By the end of 1996, 17 new banks were established, including Banking of Communications, CITIC Industrial Bank, China Merchants Bank and so on. Since their business areas are not restricted by state, they can operate fairly freely (Yuan,2006,p519-520). In addition, the central government allowed local governments to establish local banks in the mid-1990's and they took the form of shareholding banks whose business scope is restricted to their own localities (Wong Y.C. and Wong M.L.,2001,p22).

The most important milestone in banking reforms is the passing of the first commercial

bank law in March of 1995. The most important feature of the law is that it allows commercial banks to operate independently except in the case of national emergency (Wong Y.C. and Wong M.L.,2001,p20-21). This law enhances the competition between the commercial banks, further distinguishes the policy banks from the commercial banks, and accelerates the liberalization of the financial market in China.

In the last 30 years, Chinese banking system has changed dramatically; the development of the financial system has accelerated its economic growth. By the end of 2007, the total deposits and loans of all banks in China were 40105 billion RMB and 27775 billion RMB, respectively. The total asset in 2007 was reaching 52598 billion yuan (CBRC,2007,p139, 141).

### **2.2.2. WTO Regulation on the Chinese Banking System**

The 2001 accession of China into the WTO had a profound impact on China's economic growth. In the long run, the accession will enable Chinese economy to become more integrated into the world economy and allow better access to foreign technology, capital and the global market (Lin, 2008, p14). Opening the banking system to foreign banks was one of the most sensitive issues in the bilateral negotiations for WTO accession. The entrance of foreign banks has had a large impact on China's domestic banks. According to the WTO accession agreement, with a five-year grace period, the Chinese government has faithfully honored its commitments. The customer restriction on the foreign exchange business of foreign banks was removed in 2001 and the RMB (Ren Min Bi) business activities of foreign banks were gradually expanded from Shanghai, Shenzhen, Tianjin and Dalian to other cities. Foreign banks were allowed to extend their RMB business clients from foreign enterprises and individuals to domestic corporations and residents. In addition, the other restrictions such as a limit of RMB liabilities not exceeding 50 percent of foreign currency liabilities was removed and proportional limitations of foreign currency deposits accepted by foreign banks in domestic markets were relaxed (CBRC,2007, report on the opening-up). When the WTO accession agreement is

completely implemented, foreign financial institutions will be treated in the same manner as domestic firms. The state-owned banks, as well as joint-venture banks, will lose their existing protections and the competition in China's financial market will become stronger. At the end of September 2007, 25 foreign banks had been incorporated in China and had opened 95 branches. They had also established 133 direct branches. Most of these foreign banks came from the United States, European Community (EC) and Japan. So far, the US has established 8 direct branches and two US subsidiary banks have opened 10 branches. Meanwhile, the EC has established 46 direct branches and 27 local branches by four subsidiary banks in China. As for Japan, nine direct branches and two subsidiary banks were set up (Raja and Geneva, 2007). Table 2 describes the process of opening up the business scope and geographic restrictions for foreign banks after 2001. In 2002, there were no restrictions of foreign currency for the foreign banks. Foreign banks in 9 cities are allowed to operate the RMB business. Meanwhile in 2003, the restriction of RMB business to Chinese enterprises was removed in 13 cities in the following two years; this number of cities was extended to 20. There was no geographic restriction in 2006 and from then on foreign banks were allowed to operate RMB business for all Chinese clients. The table below shows the relaxation of the rules after WTO accession.

**Table2: Opening Schedule for the Banking Sector after WTO Accession**

Year	Business Scope	Geographic coverage
2002	No restriction of foreign currency business	RMB business in 9 cities
2003	RMB business to Chinese enterprises	13 Cities
2004	RMB business to Chinese enterprises	16 Cities
2005	RMB business to Chinese enterprises	20 Cities
2006	RMB business to all Chinese clients	No restriction

Source: WTO data cited in Huang(2004); Yao et al. (2007) p633

### 2.3. China's Contemporary Banking System

At present, the banking sector still dominates China's financial market, with bank

lending representing the main channel for business companies' financing. By the end of 2002, the total assets of the banking sector were 26.4 trillion yuan, which accounts for 85% of total assets of the entire financial sector. Although along with the development of capital markets, the financial channels have become more diversified. The size of the capital market is still very small, with a capitalization of 1350 billion yuan at the end of June 2003 (Luo,2003,p2).

During the last 30 years, China's banking sector has developed dramatically and the ownership of banks has become more diversified. By the end of 2007, there were 3 policy banks, 5 state-owned commercial banks, 12 joint-stock commercial banks, 124 city commercial banks, 42 urban credit cooperative, 8509 rural financial institutions, as well as 153 different types of financial institutions and 29 foreign financial institutions (CBRC, 2007,p149). The top three types of banking institutions, as measured by asset scale, were state-owned commercial banks, joint stock commercial banks and rural cooperative financial institutions, which accounted for 53%, 14% and 11% of the total assets of the banking sector, respectively in 2007 (CBRC, 2007,p29).

However, the four state-owned banks account for 61% of the loans that has persisted in monopolizing the banking system. Some academics argue that China's oligarchic market will lead to lower efficiency for allocating financial resources and result in distortions in the system (Luo,2003,p2). In addition, the 12 joint-venture banks have expanded rapidly in recent years. From 2003 to 2007, the asset of joint venture banks has increased from 2959 billion yuan to 7249 billion yuan, which represents an annual increase rate of 21.9%. Meanwhile, the pre-tax profits increased dramatically as well, which was from 14.7billion yuan in 2003 to 43.4 billion yuan in 2006, with the annual growth rate of 37.56% (CBRC,2006,p137).<sup>2</sup>At present seven joint-stock banks are already listed in local stock exchange. Furthermore, the 124 city commercial banks represent 6.35% of total banking institutional assets compared with 8.5% of urban and

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<sup>2</sup> According to the data from CBRC report 2006,2007, author calculates annual growth rate.

rural credit cooperatives at the end of 2007 (CBRC,2007,p139).<sup>3</sup>

Foreign banks have played a positive role in China's banking sector even though their function is still very limited in this system so far. In recent years, with China gradually opening its financial system, foreign banks have grown sharply. In 2006, there are 312 business offices and the total assets are 927 billion which represents three times more than that in 2003. At the end of 2006, the foreign banks represented 2.11% of total banking sector assets (CBRC,2006,p45). In addition, foreign banks account for 0.3% in the local currency lending market and around 13% in foreign currency lending market in 2003 (Luo, 2003,p3). The table below presents the current banking system in China.

**Table 3: The Current Banking System in China**

Type of the institutions	Name of institutions	Number of legal entities (2006)
Central Bank	People's Bank of China	1
Supervisory Body	CBRC	1
Policy Bank	CDB; IEBOC; ADBOC <sup>4</sup>	3
State Owned Commercial Bank	ICBC; ABC; CCB; BOC; BOCOM	5
Joint-venture Commercial Bank	See footnote <sup>5</sup>	12
City Commercial Banks	No detailed data	124
Urban Credit Cooperatives	No detailed data	42
Rural Financial Institutions	No detailed data	8509
Non-Bank Financial Institutions	No detailed data	148
Postal Savings Bank	No detailed data	1
Financial Asset Management Companies	No detailed data	4
Foreign Banking Institution	No detailed data	29

Source:CBRC Annual report 2007, p149 appendix 8-15

<sup>3</sup> According to the data from CBRC report 2007, author calculates the ratio of total assets.

<sup>4</sup> China Development Bank; Import and Export Bank of China; Agricultural Development Bank of China

<sup>5</sup> China Citic Bank, China Everbright Bank, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Corporation, Evergrowing Bank, China Zheshang Bank and Bohai bank

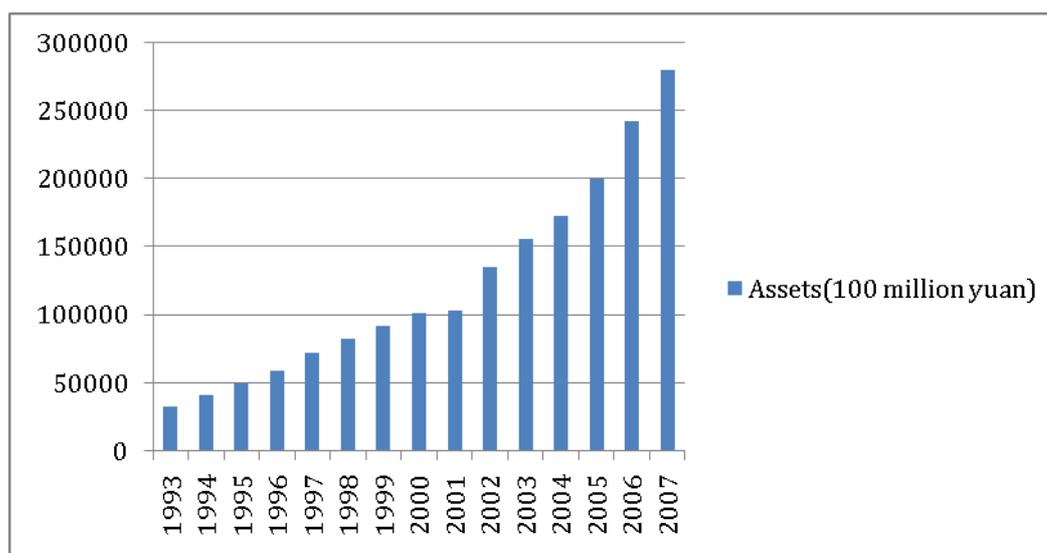
## 2.4. Performance of State-Owned and Non-State Owned Banks after 1978

### 2.4.1. State-Owned Banks

#### Banking assets

Assets of the banks are key factors in describing the scale of the bank. The increase of the bank's total assets represents the growth of the bank. From 1993 to 2007, the total assets of state-owned banks increased dramatically from 3319 billion yuan to 28007 billion yuan, which is an increase of 24688 billion yuan. (See Graph 1.) At the end of 2006, the large state-owned commercial banks had assets accounting for 55% of the total assets of the banking sector. However, the share of SOB's assets, as a percentage of total banking assets, has been declining over the years, with a decrease of 2.93% points from 2003 to 2006 and 0.91% point from 2005 to 2006 (CBRC, 2006,p30).

**Graph 1: Total Assets of State Owned Bank**



Data from 1993-2005 is from China financial statistics 1949-2005, p882-902

Data 2006-2007 is from CBRC Annual report appendix 7-1; p139

#### Profitability

Profitability is an important factor to describe the performance of state-owned banks and reflects their operational situation. Profitability here is measured through a pre-tax profit/assets ratio. Since the mid-1980's, the profitability of SOB's has decreased dramatically, from 1.4 in 1985 to 0.8149 in 2006. (See Table 4) From 1985, the

competition between state banks gradually increased with four SOB's having the right to expand their business scope. Along with the liberalization of financial market, some joint-venture banks and financial institutions were set up that increased the competition of the banking sector. In addition, even though three policy banks took a part of policy loans from the big four SOB's, the SOB's still issued policy loans from the central or local governments. Policy loans are the main reason for low profitability and poor performance. At year-end of 2000, the four largest SOB's,(ICBC),(ABC),(BOC) and (CBC) have achieved a rate of return on assets that ranked them 875<sup>th</sup>, 922<sup>nd</sup>, 830<sup>th</sup> and 764<sup>th</sup>, respectively, among banks in the world. According to the capita/asset ratio, the four ranked 725<sup>th</sup>, 541<sup>st</sup>, 758<sup>th</sup> and 749<sup>th</sup> accordingly (The Banker, July 2001, Laurenceson and Chai, 2003,p46).

**Table 4: Commercial Performance Measures in China's State Banks**

Year	Profitability	Year	Profitability
1985	1.4	1994	0.4
1986	1.3	1995	0.3
1987	1.4	1996	0.3
1988	1.1	1997	0.3
1989	1.1	2003	-0.02
1990	0.9	2004	0.0265
1991	0.9	2005	0.0779
1993	0.7	2006	0.8149

Notes:

1. Profitability is calculated as per-tax profit/total assets (%)
2. Capital adequacy is calculated as paid in capital/total assets (not adjusted for risk) (%)

Source:

3. Data for 1985-96 is from Lardy (1998, pp.93, 100) Chai and James, 2003,p212
- 4.Profitability data for 1997 is from the Banker, July 1998, P178. Capital adequacy data for 1997 is from ACFB, EE (1998, pp.194, 195,196,198) Chai and James, 2003,p212
5. Data for 2003-2006 is from CBRC annual report 2006.

### **Asset quality**

The PBOC (1999) has estimated that 20 percent of total loans of SOB's are non-performing loans, and that 6% of total loans from these banks are irrecoverable. According to the Bank for International Statements (BIS), 5% of non-performing

loans are acceptable, while 10% are considered dangerous (Saez,2004,p12). After the deepening of Chinese financial reforms, the non-performing loans of state-owned banks decreased in the intervening years. By the end of 2007, the non-performing loans were 1115 billion accounting for 8.05% of the total loans (NPL's of commercial bank,2007). While this shows a dramatic decrease, comparing with the BIS standard, non-performing loans of SOB's are still a critical problem in Chinese banking sector.

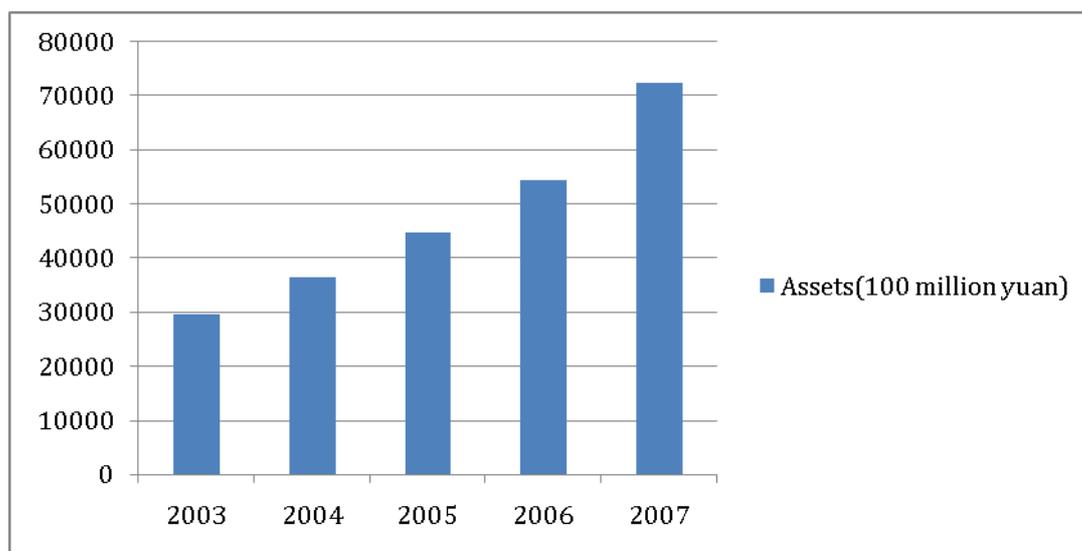
#### **2.4.2. Joint-Venture Banks**

Joint-venture banks, as the new type of commercial banks in China have developed dramatically during these years. The total assets increased to 7249billion yuan in 2007 that is almost as much as three times of that in 2003 (CBRC,2007,p139). At the end of 2006 the total assets of joint-stock commercial banks had accounted for 12% of the total assets of the banking sector (CBRC,2006,p30). Meanwhile, the profitability (pre-tax profit/assets ratio) increased sharply from 0.495 in 2003 to 0.797 in 2006.<sup>6</sup> The development of the joint-venture banks has improved with the financial liberalization that allowed it more space to grow and get more opportunities to compete with state-owned banks. Furthermore, according to CBRC's report, at the end of 2007, non-performing loans of joint venture banks are at 86 billion yuan that accounted for 2.15% of the total loans (NPL's of commercial bank,2007). The rate of non-performance shows joint-venture banks have potential to extend their share of the market in this monopolistic banking system and can have a vastly better loan portfolio than their SOB's counterparts.

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<sup>6</sup> According to CBRC 2006 annual report: Appendix8-1 and 8-5 and calculate by myself. P133, 137

**Graph 2: Total Assets of Joint Venture Banks**



Source: CBRC annual report 2007 p139 Appendix 7-1

## **2.5. Challenges Facing China's Commercial Banks**

### **2.5.1. State-Owned Banks**

After China joined the World Trade Organization (WTO) in 2001, China had to gradually open its banking market to international competition in the following 5 years. Chinese banks will face increased competition and they will have to compete with foreign banks and other overseas financial institutions in the free market. After several years of financial systems reform, China's banking sector still has many problems, most notably, the SOB's dominated financial system, highly leveraged enterprises, excessive lending and huge build-up of bad debts (Lardy 1998a, Peng 2007,p1). Even though China's banking sector is still dominated by the four state-owned banks, they face competition, not only from foreign competition, but also from some newly formed joint-venture commercial and financial institutions. The SOB's face obstacles that hinder their development. In the following part, I will summarize these problems.

#### **Unspecified property rights**

One of the biggest problems of state-owned banks is unspecified property right. Before BOC and ICBC are listed in Shanghai Exchange, the four state banks were

wholly owned by the state. Theoretically, the ownership of SOB's belongs to Chinese people but it was impossible for Chinese people to exercise their rights in banks' assets and monitor their management. Therefore, the government represents the people and became the owner of the state banks (Kagawa,1999;Peng, 2007,p8). But the central government did not clarify which government department or agency should take full responsibility for SOB's performance (Peng,2007,p8). There is no clear principal who should be monitoring the managers and who should take responsibility for the state banks' performance. So for state banks they have no incentive to improve their performance, increase their profit and enhance their inner management.

### **Unclear authority of bank managers**

There is still no clear authority between the function of banking managers and communist party members within the bank hierarchies even though corporatization has been undertaken since the mid of 1990's (Hawes and Chiu, 2007,p220-221). It's very common that at every level of state-owned banks, the president holds senior positions on their party committee as well and in some banks the important positions are required to be party members. Such situations lead to the party interfering in state-owned banks. For instance, the obvious problems with party intervention in state banks are personnel appointment, wage setting, or deployment of demobilized soldiers (Peng,2007,p9)regardless of skill level. Due to the managers of state-owned banks still facing pressure from central and local party leaders, the state-owned banks have to grant loans for supporting projects that can accelerate the local economic growth via party line of authority even if such projects are not economically viable. In order to avoid jeopardizing their own careers, the bank managers always comply to provide these loans (Hawes and Chiu, 2007,p223). Therefore, unclear authority of bank managers impedes the growth of SOB's and can result in the issuance of loans for non-economic reasons.

### **Multiple objectives**

Multiple objectives of state banks are the inherent problems. Due to the fact that state banks are born with different roles, they fulfill a dual function of being a policy bank and a commercial bank. As mentioned above, SOB's are defined as development banks. State banks are an integral part of governmental bureaucracy whereby presidents are appointed by party leadership, hence, the chief priority is to carry out government orders and directives. State banks are often assigned multiple and conflicting goals such as ensuring employment, bridging the regional gap, and providing credit to SOE's, maintaining stability of the financial system, and maximizing profits (Peng, 2007,p8). The multiple objectives agenda distort their incentives and impair their enthusiasm and ability to pursue profits.

### **Government intervention**

State banks have the inherent characteristics of being controlled not only by central government but also the local government. Even after 1994, when the three policy banks were established, the state banks have continued to be burdened with policy loans. The main categories of policy lending are as follow: (1) loan for investing in fixed assets of basic industry and infrastructure; (2) loans for working capital for purchase of agricultural and import/export products; (3) loans for poverty alleviation, regional development and R&D activities (Peng, 2007,p13).

Due to the gradual opening of China's market, SOE's face huge challenges and competition from other type of enterprise (private firms TVE's and etc). Therefore, in order to protect the big SOE's from market competition, the government force SOB's to provide credit to SOE's that are operating at a loss and facing debt problems. From 1991 to 1996 (Table6), the proportion of policy loans still account for more than 35% of bank loans. Even in 2003, the loans to SOE's from state banks are about 50% of total state bank loans (World Economic Report 21 April 2004, Peng, 2007,p15). In addition, these loans to SOE's are at a very low interest rate. Some of them are even lower than standard deposit rates. The PBOC only subsidizes a portion of the losses

from these loans and the local banks have to absorb the remaining losses by themselves (Lu,2000; Peng,2007,p14). Furthermore, state banks receive interference not only from central government but also by the local government. Local governments force state banks to support local construction projects, firms or industries that affects their profit return resulting often in losses.

**Table6: Policy Loans in China’s Four State Banks in Selected Years, 1990s(RMB billion)**

Policy loans	1991	1992	1993	1994	1995	1996
Investments in fixed assets	191	196	274	390	538	663
Purchase of agricultural products	187	186	227	314	359	370
Purchase of products for exports	179	214	259	289	327	374
Agricultural loans	121	145	172	155	192	237
Policy loans total	678	741	932	1148	1416	1644
Total loans by state banks	1804	2161	2646	3244	3939	4743
Proportion of policy loans (%)	37.6	34.3	35.2	35.4	35.9	34.7

Source: Huang 1998:6; Lardy 1998b: 78; Peng 2007 p14

### **Non-performing loan**

Non-performing loans are one of the most critical features of the Chinese banking system and one that often appears due to the problems discussed above. Due to the multiple objectives of the Chinese state banks, non-performing loans are an ineluctable problem. The reasons for non-performing loans in state banks are issues such as the loans for infrastructure construction with very low interesting rate and some preferential loans for key industries. But the main non-performing loans come from the loss of SOE’s. SOB’s have to provide capital loans to the loss-making SOE’s that distort the aim of the commercial bank and produce the huge nonperforming assets. Along with the deepening of economic reforms, SOE’s face more competition in a gradually open market. A lot of them are in debt crisis. In order to protect the SOE’s in the free market, central and local governments force SOB’s to provide credit to rescue these SOE’s which in turn increases the huge loss of the SOB’s. In this

context, the structural problems of SOB's cannot be successfully solved unless the SOE's are at least partially rehabilitated and become credit-worthy borrowers. By the end of 2000, 51.2% of the 62,000 firms that had completed their changes of ownership had failed to repay bank loans (Luo,2003,p7). At the end of 2005, the general NPL ratio of the four state banks is still above 10 percent (CBRC website; Peng,2007,p18). As long as state banks are burdened with policy loans and are meddled with by the central and local governments, the non-performing loans will never be reduced. In addition, "relationship lending" is another important reason for NPL's. Due to the lax supervision of bank managers at branch levels, branch managers provide loans to favored clients with whom they have had personal or family connections and can return the benefits, gifts and bribes to the managers (Hawes and Chiu, 2007,p210). "Relationship lending" destroys the banking risk control system and increase the risk of loans and many of which turn out to be worthless, resulting in huge losses for SOB's.

### **Foreign competition**

It was a milestone in China's history when China became a member of the WTO in 2001. According to its commitment to the WTO, China has to remove the geographic and customer restrictions within five years, allow foreign banks to set up branches in all other cities, conduct local currency business and provide retailing business (Lin, 2008, p15). Before WTO accession, the main business of foreign banks was channeling foreign funds for investments in China, and providing financial services to foreign companies. After WTO accession, foreign banks will have more opportunities to deal with domestic business and in Chinese financial markets. Foreign banks, with their modern banking skills and technology, have to a large extent increased the competition of the banking system. At the end of 2006, there were 312 business offices and total assets of 927.9 billion yuan, which represent 2.11 percent of total banking sector assets (CBRC,2006,p45). On 6 December 2007, foreign banks were allowed to deal with RMB business, which means China has been gradually

implementing their commitment and foreign banks will have more space to compete with Chinese banks in the financial markets. After WTO accession big four's monopolistic position will be ceased, comparing with foreign banks their asset values and volume of business is no larger than other major foreign banks; while their operations and techniques are less advanced than overseas banks. Therefore, foreign banks have more advantages to compete with domestic banks without any restriction in the Chinese banking market. For instance, foreign banks can easily open branches in developed, coastal regions and major cities where the China's banking business is concentrated; competing for high profits, low costs and less risky business such as international settlements. So far, data shows that foreign banks have already occupied 40 percent of China's trade settlement market (Lin,2008, p16). In addition, the current competitive position of Chinese banks is still not strong enough to compete with foreign banks in terms of financial muscles and international experience. For example, the second largest bank of UK, the Royal bank of Scotland, generated £ 6.19 billion of pre-tax profit in 2003 with only 12,000 employees, which means that each employee generated more than £ 50,000 on average of profit (Yao et al,2007, p632). Obviously, none of the Chinese commercial banks can compete with the Royal Bank of Scotland in terms of efficiency and profit margin. The table below reveals the distance of performance between Bank of China, which is one of the best performing state banks in 2002 and the three top world-class banking. From the table we can find that the net income/equity of CITIC bank is almost three times that of bank of China, meanwhile, net income/asset of bank of China is only one fourth of CITIC bank, and its net interest operating profit/asset is only one eighth of HSBC. This table proves that without protection, China's state banks still face the big challenge to compete with foreign banks in a completely open market.

**Table 7: Comparison of Profitability Level in 2002(%)**

	Net income/equity	Net income/asset	Net interest revenue/asset	Operating profit/asset
CITI Bank	15.29	1.27	4.36	7.16
HSBC	12.2	0.938	2.07	3.58
Credit Agricole	7.18	0.42	1.24	2.69
Bank of China	4.16	0.303	1.5	0.44

Source: Bankscope; Yao et al, 2007, p632

### **Human capital**

Human capital is the key factor to a company's efforts at sustaining growth, especially the skilled professionals that can improve the company's development. Like other Chinese state-owned enterprises, SOB's have to undertake the duty of being "socially responsible". One of the main consequence of this duty is they have to avoid large-scale layoffs of staff and keep social stability. Hence, the restrictions on firing workers that can lead to diminished profits (Hawes and Chiu, 2007,p226). These factors lead to the serious problems of SOB's overstaffing and inefficiency. According to Chinese analysts, the big four banks currently employ almost 1.5 million staff but in comparison with major multinational banks, only 300,000 staff are required to deal with an equivalent amount of assets. In other words, four out of five staff in big four banks are redundant (Hawes and Chiu, 2007,p227).

### **2.5.2. Joint-Venture Banks**

Due to the fact that non-state owned banks face harder budget constraints, it's easier for them to adjust management strategies to adapt to the competition from a gradually opening financial market. Therefore, the asset quality of joint-venture banks is better than state banks; meanwhile they have healthier balance sheets. However, due to joint-venture banks growth in this monopolistic system, they face discrimination and unfair competition in the financial market. After China's WTO accession, joint-venture banks faced more furious competition from both the internal and external environments. There is a general belief that joint-venture banks are much

riskier than state banks. For instance, shutting down of the Hainan Development Bank in 1998 made the depositors lose their confidence in the joint-venture banks. Even though all deposits have shifted from joint-venture banks to state commercial banks and the government paid full restitution to the depositor, confidence was shaken and joint-venture banks have yet to fully recover their reputation (An and Yang, 1999; Wong Y.C. and Wong M.L., 2001,p27). Therefore, it's still very difficult for them to extend their business scope and attract deposits. In addition, joint-venture banks are constrained by the PBC in their operational business that encumbers the development of joint-venture banks. An example is how joint-venture banks have been discriminated by PBC's lending policy. From 1994 to 1998, PBC extended only a very small portion of its loans to them which was less than 1 percent of its total outstanding loans. In addition, they are not allowed to issue bonds internationally (Wong Y.C. and Wong M.L., 2001,p30). Furthermore, joint-venture banks' pressure is not only from the state banks but also from the foreign banks. After the WTO accession, foreign banks joined the competition in the Chinese financial market. Modern management and advanced technology are the key advantages of the foreign banks. In order to compete with foreign banks the central challenge for joint-venture banks is to improve their inner management. In addition, compared with foreign banks and state-owned banks, joint-venture banks don't have enormous capital and widespread outlets for distribution, therefore, they aren't able to provide loans for the huge infrastructure projects that impede their ability to extend their business scope (China Business Summit,2003).

### **3. Case Study of China CITIC Bank**

#### **3.1. Development of China CITIC Bank**

China CITIC bank is one of the most recently emerging commercial banks founded in the early stages of Chinese economic reform in 1987. The bank is subject to the management of CITIC group with one legal entity including a two-tier management. In May 1992, the Bank set up the first Chinese foreign currency Automatic Teller

Machine (ATM) cooperating with American Express Co. In 1995, the bank offered USD 9.93 million to a state-owned company for exporting a production line that was the first export buyer's loan in China. In addition, China CITIC bank in cooperation with Lehman Brothers, issued \$200 million dragon bond for Ford Auto, which was the first bond for a Chinese financial institution involved in this area (CITIC annual report 2000).

In 2007, China CITIC bank was listed on A and H shares which was a milestone for the whole bank's development. After more than 20 years development, China CITIC bank has become one of the most competitive banks of all joint-venture banks. At the end of 2006, the total asset of CITIC bank is 706.9 billion yuan, up 111.9 billion yuan from previous year and representing an increase of 18.8 percent. Meanwhile, the customer deposit was 610 billion yuan with an increase of 100 billion yuan and the per capita net profit was 600000 yuan. The growth and the total of deposits both ranked second among small and medium-size banks in China. Meanwhile, the savings deposits and loans exceeded 100 billion yuan and 460 billion yuan respectively, becoming the second commercial bank to exceed the 100 billion yuan benchmark for saving deposits and ranked first for all small and medium-sized joint-venture banks for deposits. According to the British magazine "The Banker", China CITIC bank was ranked the 134<sup>th</sup> largest bank in the world in terms of total assets at the end of 2006 (Jiao,2007,p135-136). Meanwhile, the scope of its business has expanded from the simplex traditional business such as RMB deposits, loans, settlements and discount businesses to a multiplicity of business scopes which includes proxy receiving and payment, asset custody business, economic guarantee, credit certification business and economic consultancy business. The expansion of the business scope has increased the scope of competition and perfected its business structure and hence, further enhanced its general competitive abilities. So far, the bank has expanded its business in 70 countries in the world and has established 450 branches in China (Introduction of CITIC Bank,2007). As a newly emerging commercial bank, China CITIC bank has

met with great success during the last 20 years. There are numerous companies belonging to the CITIC group which is why it's easier for CITIC bank to have fixed customers and deposits by absorbing savings and dealings with these companies. At the end of 2005, the balance of loans extended to these relevant companies reached at RMB 4,492 million. Meanwhile, the balance of deposits and other banks from affiliates was RMB 3,576 million, with an increase of RMB 338 million over the previous year (CITIC,2005,p11). It's a good advantage for its growth especially at the early stage of establishment. A history of 20 years of successful development proves that the developmental model of joint-venture banks and the management ideal is suitable for the Chinese transition economy and they are getting bigger and more competitive in this monopolistic financial system.

### **3.2. Performance of CITIC Bank**

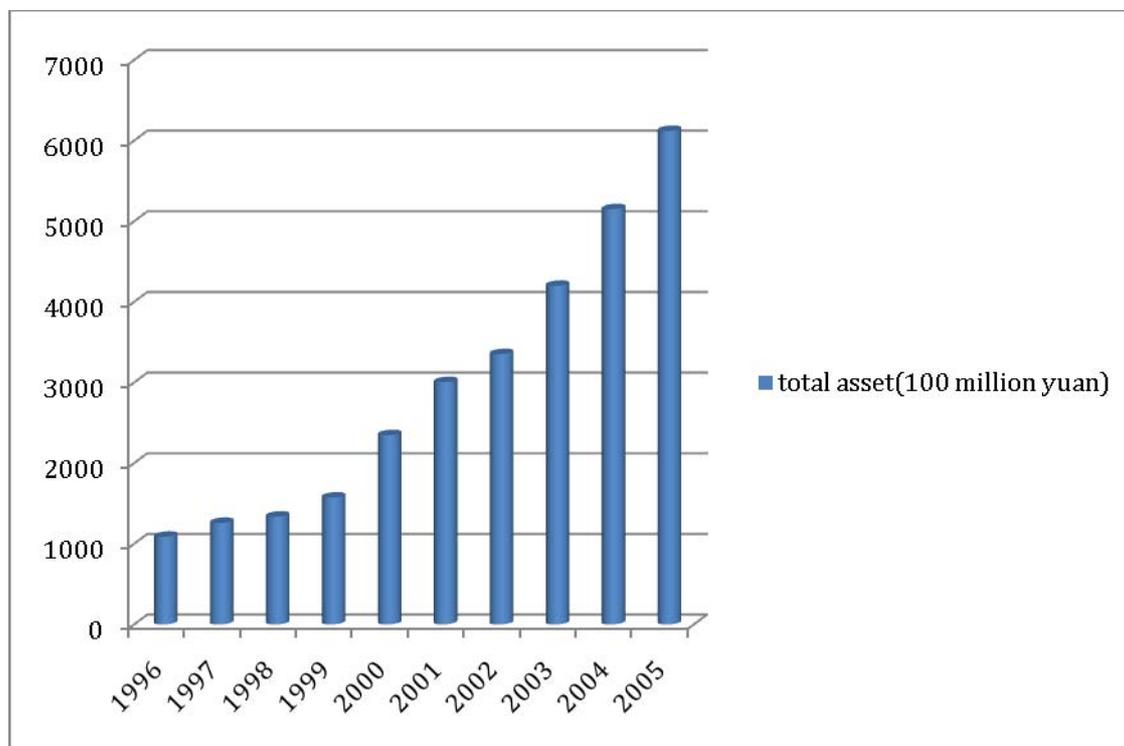
#### **Total assets**

From 1996 to 2005, the total assets of China CITIC bank increased dramatically from 108.7 billion yuan to 612.0 billion yuan, with an increase of RMB 503.3 billion, the total assets in 2005 is nearly six times as much as that of 1996. During this 10-year period, there was a substantial growth in assets, with an annual growth rate 20.40% (CITIC annual report).<sup>7</sup> This huge growth of total assets proved that along with Chinese economic growth, the management and internal structure model of CITIC bank are suitable for the monopoly financial market. According to statistics of PBOC, the compound annual growth rate of total assets, total deposits and loans of the bank were above average for all banks which were listed on A and H shares between 2004 to 2006 (Jiao,2007,p136).

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<sup>7</sup> Data is from CITIC annual report 2000-2005, and annual growth rate is calculated by myself.  
<http://www.ecitic.com/bank/about/annals.html>

**Graph 3: Total Asset of CITIC Bank from 1996 to 2005**



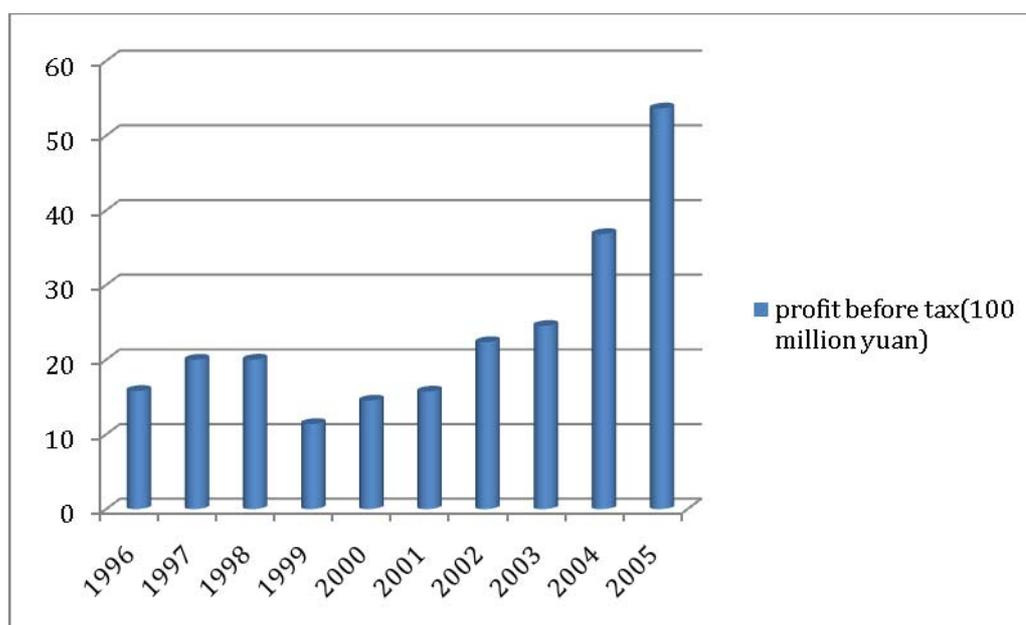
Source: China CITIC Bank Annual report 2000-2005

### **Profit before tax**

Profit before tax is the key factor to reflect the bank's performance. As of the end of the year 2005, the bank realized total profit 5.36 billion yuan, an increase of RMB 1.68 billion over that at the end of previous year with an increase of 31.36%, reaching the best in its own history. During these 10 years from 1996-2005, the profit before tax increased from 1.58 billion to 5.36 billion with annual rate growth 11.14% which is a great achievement for a newly commercial bank (CITIC annual report).<sup>8</sup>

<sup>8</sup> Data is from CITIC annual report 2000-2005, and annual growth rate is calculated by author.  
<http://www.ecitic.com/bank/about/annals.html>

**Graph 4: Profit before Tax of China CITIC Bank from 1996 to 2004**



Source: China CITIC Bank Annual report 2000-2005

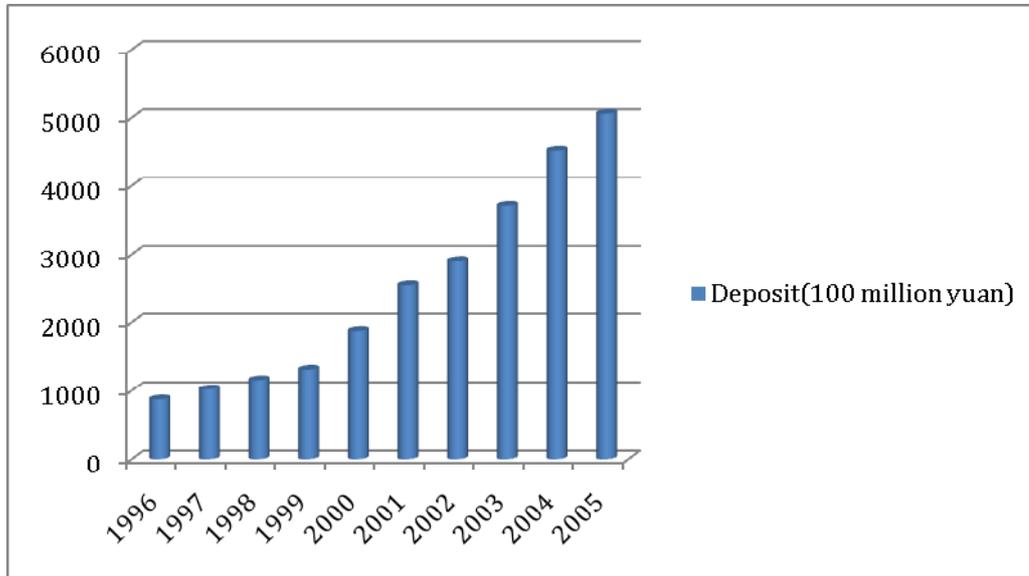
### **Growth of deposits and loans**

At the end of the year 2005, the deposits recorded a RMB equivalent of 505.93 billion. According to the statistics from its annual report, compared with the deposits 10 years ago, the figure in 2005 was nearly 6 times as much as that of 1996's. The annual growth rate from 1996 to 2005 was 21.05%. This dramatic growth of deposits illustrates the rapid increase of the bank's business scope and its customers. In view of the deposit structure, at the end of 2005, the long-term deposit was RMB 118.02 billion with an increase 2.95% from the previous year, while the short-term deposits were RMB 387.21 billion, registering a growth of 20.15%. Meanwhile, the total loans increased rapidly from 50.91 billion in 1996 to 370.60 billion in 2005 with an annual growth rate of 24.75% (CITIC annual report).<sup>9</sup> In view of this loan structure, at the end of 2005, the balance of short-term loans and medium and long-term loans reached 167.64 billion and 133.42 billion yuan respectively (CITIC, 2005, p50-51). The dramatic increase of loans, which reflects that, during this

<sup>9</sup> Data is from CITIC annual report 2000-2005, and annual growth rate is calculated by author.  
<http://www.ecitic.com/bank/about/annals.html>

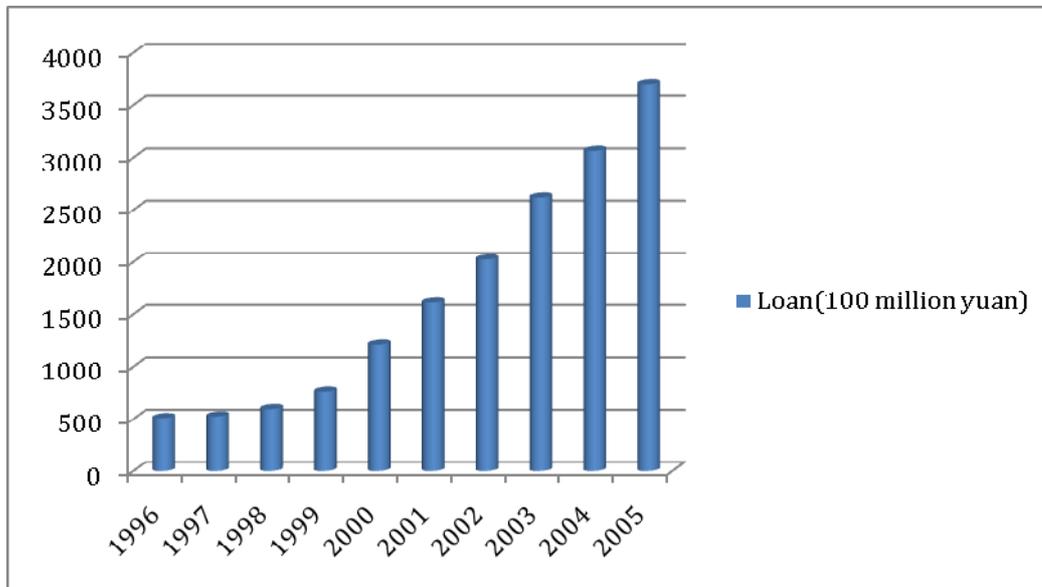
10 years, China CITIC bank continually diversified its lending category, extended its business scope and perfected the qualification of lending.

**Graph 5: Deposit of China CITIC Bank from 1996 to 2005**



Source: China CITIC Bank Annual report 2000-2005

**Graph 6: Loan of China CITIC Bank from 1996 to 2005**



Source: China CITIC Bank Annual report 2000-2005

### **Other factors affecting performance**

In 2005, the bank's capital adequacy ratio was 8.11%, which was a little bit higher than the standard 8%. Meanwhile, the NPL ratio has declined from the 18.25 billion in 2004 to 15.25 billion in 2005 with a decrease of 16.44% (CITIC, 2004,p30;2005,p24-26). The bank has improved its operating performance to a higher level. In addition, in order to extend its management scale, China CITIC bank continues to open more branches. In 2005, the total number of branches reached 418 over the entire nation. Furthermore, the bank has continually expanded the number of its employees with the number of staff increasing from 4172 to 13485 from 1996 to 2005 (CITIC, 2000,2005).<sup>10</sup> This increase in almost every aspect during the last decade reveals that China CITIC bank has achieved great success in terms of expanding its business scope, improving its assets quality and enlarging the bank's scale. The success of CITIC bank reflects that in a monopoly financial system, its ownership and management model and flexible management system adapted to economic growth and it has its own advantages to compete with state-owned banks even in this transitional economy and monopolistic market.

### **3.3. Business Strategies of CITIC Bank in Responding These Challenges**

Like other joint-venture banks in China, China CITIC bank has faced internal and external challenges after China accession to the WTO. In this monopolistic market, joint-venture banks face the competition from state-owned banks that are protected from the Chinese government. In addition, it has to compete with foreign banks that have more mature management experience and adequate capital. However, 20 years' successful development proves that a series of strategies adopted by China CITIC bank such as an inner management model, marketing strategies and organizational structures are suitable for the financial market. In the follow part, I will describe these strategies in different aspects.

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<sup>10</sup> According to data from CITIC annual report 2005; <http://www.ecitic.com/bank/about/annals.html> p18-21 of branches I calculated the number of branches by myself, the number of employees are from CITIC annual report 2005, p23 and 2000; <http://www.ecitic.com/bank/about/annals.html>

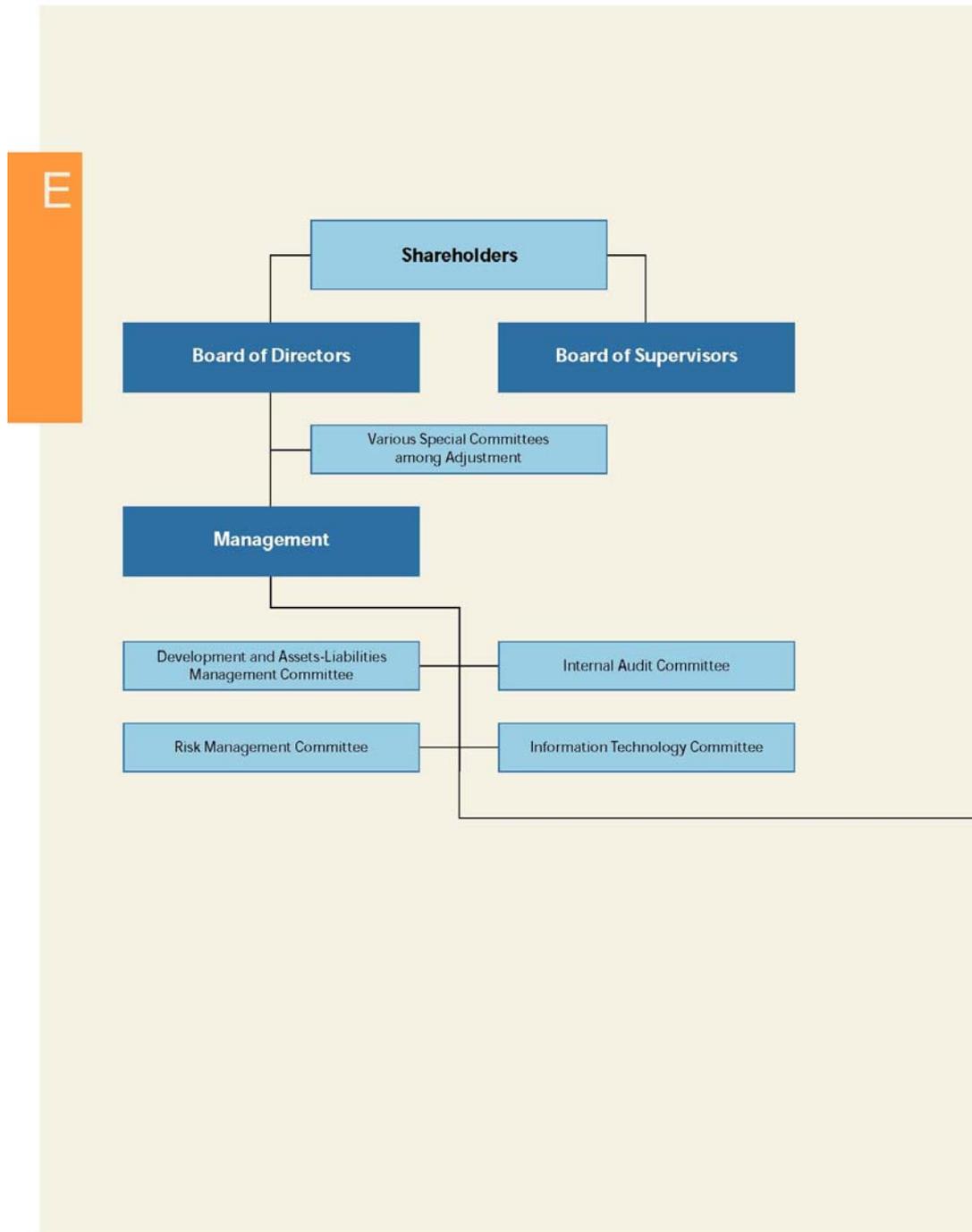
### **Improve the management and organizational structure**

Separating owner and managers is necessary for companies to accumulate capital, control risks and utilize talents. Under this management structure, the shareholders take responsibility for capital and managers have to take charge of running the enterprise (Peng,2007,p39). This management model might create efficiency far beyond any one owner/manager or even a group of owner/managers (ibid:164; Peng,2007,p39). Therefore, how to establish a scientific governance structure is the crucial factor that assures the company to achieve efficiency and reduce transaction costs. In order to achieve efficiency and profitability, the bank has greatly improved its management model and further enhanced its organizational structure. The bank adopted a CEO (Chief Executive Officer) responsibility system under the leadership of the board of directors. The CEO exercises full rights to manage capital and assets of the bank and responsibility for setting the development strategy, determining the management system and daily routine operation (CITIC, 2004,p16). The president, which leads the senior management team, is designated with management responsibilities and has to report to the board of directors (CITIC, 2005,p15). This clear separation of owners and managers optimizes the bank's organizational structure and inner management and hence, further improve the efficiency. So far, the bank has established an integrated framework of the inner organizational structure which includes the board of directors, board of supervisors, and management committees which are divided into four parts: development and asset-liabilities management committee, internal audit committee, risk management committee and information technology committee. (See graph 7.)

In addition, during these years, the bank has incessantly strengthened its organizational structure. Based on its operating needs, the function of head office is defined as a decision-making center, risk control center and an operational management center. Meanwhile, the bank readjusted the level of operations

management relationship, upgraded regional sub-branches to branches and some sub-branch offices to sub-branches in order to consolidate its branch networks and improve their role in local areas. Furthermore, the bank established a collective decision-making mechanism, which to a large extent enhanced its internal democracy and strengthened the decision-making mechanism. For instance, the bank has issued rules such as the agenda of the president's working meeting being set up both at the head office and branch level, and the regular meeting at different levels has also been set up. Moreover, the bank continues to strengthen disciplinary and incentive mechanisms. In order to strengthen functional management at different levels and enhance the incentives of competitiveness, the bank conducts performance reviews of all senior executives. The executives are rewarded for good performance and replaced for lack of productivity. This incentive mechanism increases the incentives of competitiveness in the bank, and helps to better attract talented employees and increase the efficiency (CITIC,2005,p15).

## Graph 7: Organizational Structure of CITIC Bank



Resource: CITIC bank annual report 2005, p16

### **Strengthening human resources management**

Human resource is one of the most important factors with direct influence on a company's further development. As we know, in all service industries, staff quality is a key to success and the quality of the staff is crucial in terms of delivering services, winning business clients and maintaining reputation (Peng,2007,p112). In order to enhance human resource management infrastructure and establish scientific human resource management mechanism, the bank drew up a series of human resource management policies and regulations on employee's annual appraisal, staff employment, promotion examination, and staff training and exchange of senior and medium management personnel. Through comprehensive examination and appraisal, the bank selects the management personnel to establish a team at the branch level with a focus on designing of the employees' career life. In addition, the bank established group and individual performance review methods to enhance the effectiveness of the staff. An example of this is when the bank established fair and transparent procedures and specific measures on annual staff appraisal, according to their performance to give rewards. Establishing relevant performance appraisal system and remuneration system (CITIC, 2004, P47) is of utmost importance. Furthermore, the bank encourages the employees to pursue on-the-job study and invests in training for its staff to improve their professional skill and overall competency. Meanwhile, it provides tailor-made training for key staff such as middle to high-level managers to improve their management competency (CITIC, 2005, p42).

### **Improving marketing strategies**

Due to the fact that the Chinese government does not protect joint-venture banks, people have less confidence in comparison to SOB's in China. Therefore, as joint-venture banks, they have to provide better service, financial products and efficient marketing strategies to attract high-quality clients. In order to increase their share of the market, participate in high-quality industries and acquire high-quality clients, the bank strengthens its marketing to provide tailored products and specialized

services. According to CITIC bank's credit rating, at the end of 2006, the proportion of high quality customers reached 90%, which provided stable customer and profit, enhancing its competitive edge (Jiao,2007,p137). In addition, the bank has established a steering team for wholesale client marketing at the head office who is engaged in marketing activities. Meanwhile, the team conducts on-site marketing and visits key clients to strengthen ties and communication with strategic clients (CITIC, 2005,p26). This marketing strategy improves marketing capability and perfects its marketing organization. In addition, the bank engages in cooperation with large state-owned enterprises, foreign-invested enterprises in both the head office and branches. The bank established marketing teams to provide guidance and support to local marketing campaigns. Furthermore, the bank encourages every branch to adopt a flexible product strategy, exerting its own advantages according to their own market situation to exercise differentiated marketing practice (CITIC,2004,p31).

### **Continue to product and service innovation**

Due to the fact that joint-venture banks have to face hard budget constraints in this monopolistic financial system, there is a general belief that joint-venture banks are much riskier than state banks. This traditional view to a large extent encumbers the joint-venture banks' business standing. In this underdeveloped market situation where the interest rate is strictly controlled by the central bank for different kinds of deposits, the competition between banks lie in providing good financial products and services. Therefore, how to create good financial products and upgrade the quality of service is the key factor for success. China CITIC bank continues to increase mature innovative financial business that includes auto finance, secured acceptance tranche and logistics financing (CITIC, 2004,p31). In addition, the bank provides some financial products that combine certain features of treasury agency business such as online tax collection and payment. Furthermore, in order to enhance its competitive advantages, the bank designed a non-recourse discount product under the letter of credit and third party payment-upon-delivery financing in international trade finance. Creating other

innovative products such as underwriting of commercial paper, consumer car financing and other innovative business with a market impact has helped China CITIC bank compete successfully (CITIC,2005,p27). On the other hand, the bank continues to service innovation. In order to upgrade the quality of service to mid to high-end customers, the bank builds up its branded CITIC Premium service. Over 200 VIP (Very Important Person) rooms and more than 400 VIP counters have been established in branch offices. The bank also establishes a team of nearly 500 account managers working on wealth management and providing one-to-one services for mid and high-end customers. In addition, branches are equipped with service review machines to monitor the service quality of counter staff. All these measures contribute to accelerate service innovation and upgrade service quality (CITIC, 2005,P28/29).

### **Optimizing non-performing asset management model**

To reduce existing non-performing assets is the key commission for banks to improve their performance. Compared with Chinese SOB's, joint-venture banks have comparatively lower non-performing asset rate but it is still the main obstacle for banks' further development. In order to quickly reduce existing nonperforming assets, China CITIC bank has adopted several measures to improve the situation. These measures are as follow: 1) establishment of an internal counsel and an asset preservation department to response for dealing with legal affairs and non-performing asset management in head office and key branch. 2) Perfecting the incentive mechanism and motivating staff to take charge of at-risk debt collection 3) Searching for new ways to accelerate solutions such as cooperating with asset management companies to reduce the loss. 4) Award to implement a NPL's collection plan, increasing rewards for good performance in NPL's collection and the further strengthening of NPL project management (CITIC,2005,p35).

### **3.4. Effects and Limitations of This Case Study**

The great success of China CITIC bank has revealed that their management model, business strategies and inner organizational structure are suitable for Chinese financial

market. Hence, Chinese SOB's can learn a lot from its successful experiences. However, due to SOB's inherent characteristics such as facing soft budget constraints, being strongly influenced by government and having multiple objectives, the CITIC case has its limits for SOB's to imitate. In the following chapters, I will use CITIC successful strategies to analyze how much can SOB's learn from CITIC's experience, what's the limitation for SOB's to imitate CITIC's model and what needs be done to solve SOB's inherent problems.

#### **3.4.1. How Much Can SOB's Learn from CITIC's Successful Experience?**

Comparing with private banks, one of the biggest problems of SOB's is less efficiency. As mentioned above, according to the study of Yao et al (2007), joint-venture banks outperform state owned banks by 18% in profitability and 8% in loans. There are several reasons for the inefficiency of SOB's. Some of them are caused by inherent disadvantages of SOB's. Another reason is the weakness of its inner management and organization structure. Most of SOB's lack modern and advanced enterprise management mechanisms. According to CITIC's case, SOB's can imitate its advanced management experience and marketing strategies to enhance their efficiency. SOB's might adopt four CITIC strategies:

##### **(1) Establishing scientific decision-making mechanism**

One of the most successful strategies in improving cooperate governance for CITIC bank was the establishment of a scientific decision-making mechanism. Due to SOB's implementation administration management model, each branch has been authorized by upper level branches to implement business and management activities. The decision-making mechanism in SOB's is described: state-government-head office-tier one branches-tier two branches. On account of information asymmetry and different situation in different areas, this decision-making mechanism leads to low efficiency at the branch level (Li, 2008). In addition, this decision-making mechanism causes branches to lack flexibility to adjust their strategies and lack a democratic way to

collect useful suggestions. Therefore, SOB's should learn from CITIC's advanced and flexible decision-making mechanism, for instance, setting up a president's working meetings and regular meetings at both the head office and branch level to discuss daily affairs and make decisions, establishing collective decision-making mechanisms to widely collect suggestions and delegating some decision-making rights to a lower level so that some branches can make decisions according to their own situation.

## **(2) Strengthen incentive mechanisms**

The other pivotal strategies for CITIC to improve inner management is strengthening incentive mechanisms. This incentive mechanism is very valuable for SOB's to imitate. So far, SOB's haven't established transparent and efficient incentive mechanisms. For instance, the salary of managers is fixed and their salary doesn't rely on their performance. In addition, superiors assign the managers of SOB's and the superior's recognition determines promotion regardless of performance (Li, 2008). This incomplete incentive mechanisms leads to staff's low enthusiasm in SOB's. According to CITIC's incentive mechanisms, SOB's can imitate its inner competitive mechanism and functional management which includes conducting performance reviews of all senior executives. The executives with good performance are rewarded otherwise they are replaced. This incentive mechanism will further enhance managers' enthusiasm to improve SOB's performance and maximize profits and further improve the efficiency.

## **(3) Establish perfect staff training mechanisms**

In order to establish a scientific human management mechanism and enhance the staff's overall competency, CITIC bank set up a team to design employees' career life, providing a series of tailor-made training for key staffers and increased the staff's training investment. So far, the training system in SOB's is still lagging behind. Due to the lack of efficient incentive mechanisms such as salary that is not combined with staff's performance, the staff loses enthusiasm to improve their business skill and has

no interests to increasing the value of their human capital by acquiring more knowledge. In order to improve this situation, SOB's should adopt to these strategies, establish relevant staff training system and provide employees' career life designing strategies to improve staff's enthusiasm.

#### **(4) Product innovation strategy**

Product innovation determines the core competitiveness of enterprises. Under the central planning for many years, SOB's mainly dealt with SOE's and provided simple and low value-added financial products and services. Due to SOB's lack of a competitive environment it's really difficult for them to develop new technology and create new financial products. The weak innovation capability lead SOB's to having lower quality customers and less opportunity to gain larger profits (Peng,2007,p160). In order to improve their competitive ability, CITIC bank set up a series of product innovation strategies that include creating new financial products and increasing mature innovative financial business. One of the characteristic of CITIC's innovation strategy is it exerts its own advantages, adopt flexible innovation mechanisms and, design financial products according to market's need. Therefore, SOB's can adopt CITIC's flexible innovation strategy, take their own advantages, according to the market and adjust financial products structure to improve SOB's innovation capability and enhance efficient.

#### **3.4.2. Can SOB's Imitate CITIC's Model?**

As mentioned in the theoretical framework, SOB's and non-state owned banks have their inherent characteristics and there exists huge differences between the two models. They face different challenges and have to frame different development strategies. Therefore, SOB's can imitate some advanced and scientific management strategies from CITIC's successful experience. The inherent difference between two types of bank illustrates this case study has its limitations. The intrinsic problems of SOB's lead to their poor performance and low efficiency. Therefore, to improve the performance and efficiency of SOB's they not only need to enhance their inner

management but also need the government to create a good financial environment and solve the intrinsic problems of SOB's.

### **(1) Soft budget constraints**

One of the inherent problems of SOB's is they face soft budget constraints. Unlike other SOE's, SOB's performance directly influences the entire financial market and the growth of the entire economy. Therefore, in this monopolistic financial system, government adopts different measures to protect SOB's from market competition that make the SOB's lose their competitive ability and leads to low efficiency. For instance, Chinese government issued 270 billion RMB in special bonds to help SOB's boost their capital adequacy ratio (Naughyon,2007,p462). In addition, the government injected huge funds to help the big four reduce the NPL's rate, and approximately a quarter of their NPL's were transferred to separate asset management companies(AMCs) to improve the SOB's balance sheet (Hawes and Chiu, 2007,p211). Furthermore, in order to maintain public confidence in SOB's, China's central government has explicitly guaranteed SOB's deposit (Wang Y.C., Wong M.L.,2001,p27). This series of measures weakens SOB's ability to adapt to a changeable market.

CITIC Bank in order to increase the share of its market, it has participated in high-quality industries and acquired high-quality clients, set up a series of market strategies, such as providing tailor made products and specialized services; established a team to conduct marketing strategies at both the head office and branch level; and encouraged every branch according to their market situation to adopt flexible product strategies. The efficient market strategies above seem to be very useful for SOB's to increase their competitive abilities in the market. However, government protection leads to SOB's reduces competition mechanism, as they have no incentive to exploit the new market. Therefore, if SOB's still face soft budget constraint and government still keeps SOB's from market competition, it is very

difficult for SOB's to improve their competitive capability and enhance their efficiency.

## **(2) Intervention of government**

Another typical character of SOB's is strong intervention by the government. Due to the ownership of SOB's belonging to the state, the government intervenes in SOB's to achieve its political and economic purpose. Under such government control and intervention, it's impossible for SOB's to become a true commercial bank. According to the CITIC case, one of the most important organizational structures is establishing a modern enterprise system that includes separating owner and manager, adopting a CEO responsibility system and establishing an integrated framework of the inner organizational structure. This scientific organizational structure is the important symbol of a modern enterprise system. Hence, separating owner and manager, adopting CEO responsibility and establishing sound organizational structure is a necessary way for SOB's to improve corporate governance. However, if SOB's still have unclear property rights, unclear authority of bank managers and are strongly influenced by the government it's impossible for them to establish modern enterprise system. Therefore, simply imitating advanced organizational structures and management models cannot solve their essential problem.

Another successful strategy for CITIC's case is optimizing a non-performing asset management model. At present, non-performing loans are the most serious problem that threatens commercial bank's development. CITIC bank adopted several efficient measures to reduce existing NPL, such as establishing efficient risk control mechanism and founding special departments for dealing with legal affairs and setting up incentive mechanisms to accelerate NPL's collection. These strategies to some extent reduce NPL's rate and improve asset quality. Can SOB's use CITIC's strategies to solve their problems such as non-performing loans? The answer is an emphatic no because of the influence of the governments in SOB's which means that many NPL's

are political loans. In contrast, as a joint-venture bank, the main reason for NPL's is not from government intervention, but from inefficient risk control mechanism. Indeed, China CITIC Bank's strategies to some extent can help SOB's remove some existing loans, but this function is very limited. Therefore, for SOB's to reduce government interference and establish efficient market competitive mechanisms it must reduce NPL's.

### **(3) Multiple objectives**

Another experience which shows the limitation of the strategies to be adopted by SOB's is a series of human resources management strategies which include drawing up policies and regulations on annual employee appraisal, staff employment and promotion examination and an exchange of senior and mid-level management. Due to SOB's having multiple objectives and an overlap of the roles of political bank and commercial banks, they have to take responsibilities to maintain social stability and accelerate economic growth. As a "development bank", one of the crucial tasks for SOB's is ensuring employment and avoiding large-scale layoffs of staff. Therefore, SOB's have limited rights to fire their staff. In addition, in order to realize the multiple objectives, presidents in SOB's are appointed by the government, which can easier to carry out government orders and directives. Hence, the multiple objectives of SOB's mandate make it difficult in using efficient human resource management strategies, such as using promotion exam or democratic methods to select leaders and according to their needs employ or terminate staff. The key method for SOB's to improve the human resource management is that they have to offload the burden of "social responsibility" and become the true commercial bank.

### **3.4.3. How to Improve SOB's Inherent Problems?**

In order to improve the inherent problems of SOB's and accelerate SOB's development, the Chinese government needs to speed up the process of financial liberalization and create a fair competitive environment. As mentioned above, soft budget constraints, government intervention and multiple objectives are the three

distinct characters of SOB's. Hence, what need to be done to improve SOB's inherent problems are the key point for SOB's reform and the main answer for the limitation of this case study. In the next part I will discuss how to improve these three problems respectively.

### **(1) Improve soft budget constraint**

In order to solve SOB's soft budget constraint, first, the Chinese government should gradually open its financial market, encourage more medium and small banks as well as foreign banks entrance to the market to compete with state banks (Yao et al,2007,p641); abolish some discriminatory policies to non-stated owned banks; gradually liberate the financial market and create equal competitive environment. China has shown some improvement since it gained entrance to the WTO in the way. China has opened its financial market. WTO accession to a large extent hardened the budget constraint of SOB's. However, SOB's are still protected by the government. In order to reduce NPL's rate and help SOB's list in the stock exchange, the government has injected funds twice since 1998. This protection extremely weakens SOB's competitive abilities and encumbers the free competition in the financial market. Therefore, the government should gradually abolish these protections and favorable policies to SOB's; make SOB's face harder budget constraint and become truly commercial banks. Secondly, government ought to establish a series of laws and regulations to regulate financial markets. Even though in 1995 the first bank law was enacted, rules and regulation of financial system are still very weak. Therefore, the Chinese government ought to establish an appropriate institutional framework, such as bankruptcy law of enterprises to give better protection to the legal rights of creditors and the security of banking assets (Caijian 6 February 2006;Peng,2007,p158). To sum up, the government needs to continue to gradually open financial market, reduce the protection of SOB's and strengthen laws and regulations to create a fair competitive environment as the efficient way to improve the problem of soft budget constraint of SOB's.

## **(2) Reduce government intervention**

The most serious problem, which is a direct result of government intervention, is non-performance loans. At present, the current three policy banks don't have enough capacity to undertake policy burdens. Therefore, the first thing for the Chinese government to do is strengthen the function of policy banks to reduce political loans (Peng,2007,p158). As mentioned above, simply copying the governance and organizational structure is not the essential way to improve cooperate governance, SOB's have to solve the problem of government intervention. In order to help SOB's upgrade their corporate government mechanism they must achieve a clear separation of roles between owners and managers (Wu; Chen and Shiu, 2007,p411) to reduce government intervention and clarify property rights. Stock listing seems to be efficient way to clarify property rights, strengthen the function of bank managers; and pressure SOB's face to hard budget constraints when making investment decisions. So far, four SOB's (BOC, CCB, ICBC and BOCOM) have already been listed on both Hong Kong and Shanghai stock exchanges. However, some argue that listing banks has not completely solved the existing problems of corporate governance. First of all, even though listing has further speeded up separating the owners and managers, the SOB's are still controlled by state shareholders and only small minorities of these banks' share were offered to the public (Hawes and Chiu,2007,p217). The state control is still too strong to clarify the property rights of SOB's. Secondly, Chinese government established Huijin Company in 2003 to represent the owners of the SOB's. It seems a big step to clarify the property rights. However, the status of Huijin Company is confused, the top executives' roles are assumed by government officials but it is registered as an investment company (China economic times 20, October 2004, Peng 2007,p11). Although, Huijin is the biggest shareholder of the SOB's, the right to appoint staff in banks still belongs to the central organization department of the communist party of China. This ambiguous status and insufficient power make it difficult for Huijin to implement its real function such as effectively managing state

assets (Peng,2007,p11). Even though listing cannot immediately solve the problem of government intervention, it's still one of the only efficient ways for SOB's to do so at present. The Chinese government should further clarify property rights and reduce the intervention in Huijin Company. Furthermore, SOB's have to adopt a matrix and vertical administrative framework so that the headquarters can make major decision instead of branches in order to better resist local government intervention (Peng,2007,p157). Finally, the Chinese government should reduce the intervention in the SOB's. The Chinese government should improve state capacity and establish an appropriate fiscal budget relationship between the centre and localities to prevent local bank's policy lending from local government (Peng,2007,p158).

### **(3) Solve the problem of multiple objectives perfect society mechanism**

In order to take away the burden of "social responsibility" and allow SOB's to become more market oriented like commercial banks, the Chinese government ought to further perfect social security mechanisms and establish social safety networks. Under these networks, SOB's don't need to take responsibility to ensure employment and have the free right to lay off their surplus employees. As mentioned above, one of serious problem of SOB's is overstaffed and inefficient, establishing social security mechanisms will make SOB's have free reign to optimize their staffing levels in order to maximize profit. This would be a vastly more efficient use of resources than using SOB's as merely a source of employment.

## **4. Conclusion**

China has achieved great economic progress for more than a quarter of a century since the late 1970s. At the same time, the banking sector has undergone a process of structural changes and reforms (Yao et al,2007,p629). Despite significant reforms having been undertaken during the last 30 years, Chinese banks, especially SOB's, still face a series of challenges that not only jeopardize the health of the banking system, but also endanger the stability of the whole economy. Therefore, banking reform, especially SOB's reform, is a prerequisite in order to maintain high economic

growth and the stabilization of the financial sector. This paper summarized two broader views: “development” view and “political” view to expatiate the different viewpoints about state ownership of banks and to compare the different characteristics between SOB’s and non-state owned banks. Through a review of the background of the financial system and development of Chinese banking system since 1978 and discussion of the challenges of Chinese commercial banks face after WTO accession, this paper used China CITIC bank as a case study to answer the question what can SOB’s banks learn from other non-state banks’ successful experience. This case study of CITIC bank attempted to address three questions: 1) how much can SOB’s learn from CITIC bank experience? 2) What’s the limitation for SOB’s to imitate from this case? 3) What should be done to solve SOB’s inherent problems?

According to CITIC’s experience SOB’s can imitate three efficient strategies to improve their management and organizational structures. The first one is establishing collective decision-making mechanism. Such scientific decision-making will help SOB's optimize management structure, enhance enterprise inner-democracy and increase flexibility of their branches. Another pivotal strategy is the establishment of an efficient incentive mechanism that includes conducting performance reviews of senior executives and establishing a reward mechanism to encourage good performance. This incentive mechanism will strengthen enterprise competitiveness through enhancing managers’ enthusiasm and maximizing profits.

In addition, SOB’s can adopt staff training strategies such as providing employees’ career life designing mechanisms and a series of project for tailor-made training to perfect human resource mechanisms. SOB’s can through such strategies help to improve staff’s enthusiasm and enhance their employees overall competence.

Finally, SOB’s ought to adopt a product innovation strategy. They need to increase the speed of the process of creating new financial products and increasing mature innovative financial businesses. Only through utilizing their own advantages and

going to the market to create new financial products can SOB's truly improve their innovation capability and enhance their competitive capacity in financial market.

However to discuss the methods in which SOB's should seek to effect change it is also important to discuss their inherent flaws. Simply improving inner management mechanisms and optimizing organizational structures can't solve their essential problems. Therefore, this case study has its limitation. First, facing soft budget constraint makes SOB's less competitive capacity in a market capacity. A series of CITIC's marketing strategies can't essentially solve SOB's problems. These problems include lack of market competition abilities and having no incentive to exploit new markets. With WTO accession, China in the process of completely opening its financial markets, if SOB's are still protected by the government and continue to face soft budget constrains they will gradually lose their share of the market and become a complete liability of the government with no viable business model. Secondly, strong government intervention and unclear property rights denies the SOB's the ability to simply copy CITIC's advanced organizational structure and management model to improve corporate governance. Third, the strategies for CITIC bank to reduce existing NPL's can help SOB's lower their share of NPL's. However, due to the fact that NPL's arise for different reasons between the two types of banks means that the strategies of CITIC Bank cannot completely solve the problem of SOB's NPL's. If political loans are not eliminated, it will prove difficult for SOB's reduce their NPL's. Fourth, having multiple objectives such as taking responsibilities to maintain social stability and accelerating economic growth determines that SOB's cannot imitate some human resource management strategies from the CITIC bank case. Hence, the multiple objectives of SOB's decide they cannot be as flexible in using some human resource management strategies. The key way to improve human resource management is to offload the burden of "socially responsibility" and become a true commercial bank.

This paper gives some suggestions for SOB's to solve their inherent problems. In order to for SOB's to face harder budget constraint, the Chinese government should continue to gradually open its financial market and encourage more medium and small banks as well as foreign banks to enter into the market to compete with SOB's. In addition, government should abolish discriminatory policies to non-state owned banks and create an equal competitive environment. Furthermore, government ought to establish a series of laws and regulations to regulate financial markets so that they create a healthy and fair financial market.

In addition, to solve the problem of government intervention, the Chinese government should take the following measures: 1) The government ought to strengthen the function of policy banks in order to reduce political loans (Peng 2007, p158). 2) Speed up the process of SOB's listing in order to further clarify the property rights and reduce the intervention of Huijing Company and establish a real modern enterprise system. 3) The government ought to improve state capacity and establish an appropriate fiscal budget relationship between the centre and localities to prevent local bank's policy lending being affected by local government (Peng 2007, p158).

Finally, in order to solve SOB's multiple objectives and take away from the burden of "social responsibilities", the Chinese government has to further introduce social security mechanisms and establish a social safety network so that SOB's can have free right to optimize staffing levels to maximize profit.

So far, Chinese government has adopted some measures to speed up SOB's reform. With WTO accession, China in the process of opening its financial markets and allows more competitors to participate in Chinese financial market. In addition, CBRC was established in 2003 to take charge of setting up a series of regulations and rules to regulate the banking market. Therefore, Chinese government is moving forward to solve the problem of soft budget constraint. Furthermore, at present, Chinese government is commencing on ABOC's listing. After ABOC's listing, five

SOB's are all listed on Shanghai and Hong Kong exchange stock. However, the SOB's are still controlled by state shareholders. It still takes a lot of time to truly clarify the property rights of SOB's and reduce the intervention of Huijing Company.

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