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Understanding of the gap between city commercial banks
and state-owned banks in China
-----Examples for Shanghai and Guiyang

Xin Zhang

zhangxin1112@hotmail.com

Abstract: This paper is for understanding the gap between city commercial banks and state-owned banks. In our image, the gap is existing for a long time, but how large is large, could it be changed. Through the quantitative analysis using CAMEL rating system, the conclusion is the performance of city commercial banks is weaker than state-owned banks from capital adequacy, assets quality, management, earnings and liquidity. However, the gap is narrowing, the city commercial banks are expected to be stronger to compete with the state-owned banks. In that case, the whole banking sector of China would be improved by competition, the financial market is not only the games of four financial magnates. At last, the paper pointed out the development of city commercial banks need appropriate strategies which are coordinated with its own local economic growth. It provides four strategies based on case study in order to narrowing the gap with state-owned banks.

Key words: gap, CAMEL rating system, strategies

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1. Introduction:

The city commercial banks are important component of China's banking sector, however, they are special financial institutions to be arranged by central government in the eightieth decade of the twentieth century. Their predecessor is the urban credit cooperatives which have strong relationship with local governments from a historical perspective. The original purpose to set up urban credit cooperatives is service for local medium and small business, what's more important, they have strong responsibility of supporting local economy.

In the mid of ninetieth decade of twentieth century, the central government organized city commercial banks based on urban credit cooperatives for resolution of local financial risk. In the past decade, the city commercial banks are developing very fast, on one hand, city commercial banks diversify the ownership structure to improve their management. It means they are shaping the power of local government to act for profitability objects instead of a financial branch affiliated to government. They made great effort to reduce its non-performing assets and ratio of bad loan, take more market share in local economy. On the other hand, the development of city commercial banks are uneven distribution. The best city commercial banks such as the Bank of Shanghai have great potential to rival with state-owned banks, which be in the list of top 500 banks in the world. However, most city commercial banks still have problems in

operation and management. My thesis will try to find out the existing problems why the city commercial banks are generally fall behind of state-owned banks. In second part, I measure how large is the gap between city commercial banks and state-owned banks using CAMEL rating system. At last, I try to figure out the appropriate strategies for city commercial banks.

1.1 The state-quo of city commercial banks

The city commercial banks have longer history in China and they take the greatest number in banking system. Since 1995, the urban credit cooperatives were reformed as city commercial banks which are initial framework of Chinese modern commercial banks. The city commercial banks were stick to the principle that “focusing on the small and intermediate industries, serving the citizens and society with best quality” in more than ten years. It’s no doubtful they made contribution to local economy.

However, they do not have a advantages as state-owned banks which are supported by the central government, not as the newly joint-stock banks which have no repondibility of non-performing assets accumulated by historial reason. In the banking system of China, they face fierce competition, We could analyze their survival environment from the statistical figures.

I consult the rankings of China’s commercial banks in 2006¹ and 2007² published by The Banker magazine which is a global financial intelligence; it is helpful to gain a brief idea the position and role of City Commercial Banks in banking system of China. The data is from first and second “Top 100 Chinese Banks”. The ranking based on Tier 1 capital³ which was occupied the first Four positions by four big state-owned commercial banks, including Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China and China Construction Bank. In the ranking of 2006,

¹ Beijing lauch of Top 100 Chinese banks .3rd July, 2007. The Banker.

² Beijing hosts launch of Top 100 listing. 2nd July, 2007. The Banker

³ Tier 1 capital has definitions given by The Basel Capital Accord in page 4,section "The constituents of capital (a) Core capital (basic equity)"

China Construction Bank successfully financing 9200 million through IPO⁴ at end of 2005 in Hong Kong which exceeds Industrial and Commercial Bank of China. The second one is Bank of China, the third one is ICBC, and the fourth is ABC. But in the ranking of 2007, due to IPO of ICBC and Bank of China in Hong Kong last year, they rank the first and second respectively. The next are CCB and ABC. Although the four commercial banks already be listed, the control right is still belongs to government. They are powerful and they are leaders of China's commercial banks.

The second group is joint-stock commercial banks which in representation of Communication Bank of China. The third group is city commercial banks which take greatest number of list. There are 65 city commercial banks listed in the top 100 Chinese banks. Although the number in this group is the biggest one, but the total assets of city commercial banks only take 5% of all the banks in China. Moreover, in most cities of China, the city commercial banks have lower petty deposits than four state-owned banks, it leads that the city commercial banks have to pay their attention to local small and medium enterprises. It is worthy to notice that the growth of city commercial banks is differentiation because they are in the different areas. The Banker magazine pointed that in the coastal areas which are more developed area of China, the business circumstance of small and medium enterprises are better, and the local governments have greater financial strength. The development of city commercial banks is obviously superior to those located in Midwestern cities.

The fourth group is eleven rural commercial banks in China. They only account for a small percentage in capital, assets and pre-tax profit. At the last, there are 8 closed-companies include the branches of international banks, the banks hold by foreign shareholders and some domestic commercial banks which only engage specific services.

⁴ IPO is an acronym for Initial Public Offering. It is the first sale of a corporation's common shares to public investors. The main purpose of an IPO is to raise capital for the corporation.

The charts below show that the four state-owned banks, the joint-stock commercial banks and city commercial banks take 77.7%, 15.1% and 5.4% of total Tier 1 capital of top 100 Chinese banks respectively. As for banking assets, the percentages of state-owned banks, joint-commercial banks and city commercial banks are 73.3%, 19.2% and 5.6%. The three groups of banks take 74.7%, 19% and 4.6% of pre-tax profits respectively. Whereby the total Tier 1 capital of Top 100 Chinese banks was USD 2129 00 million, the total assets was RMB 32.2176 trillion, the total pre-tax profit was RMB 291.6 billion.

Table 1 Tier1 capital %

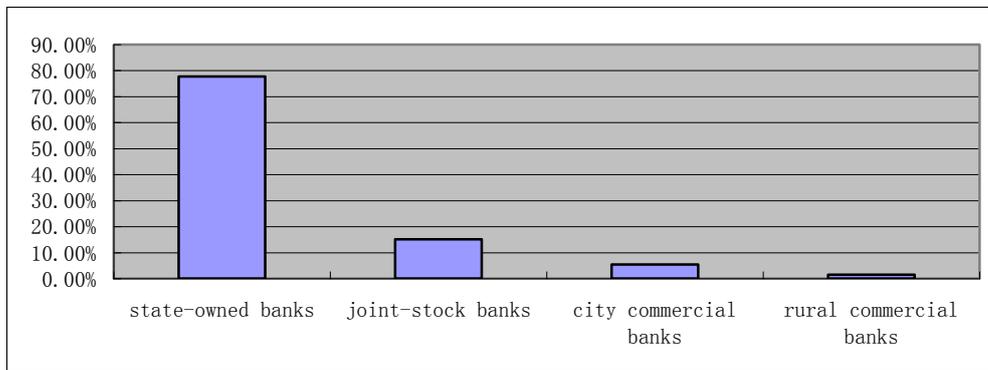


Table 2 Assets %

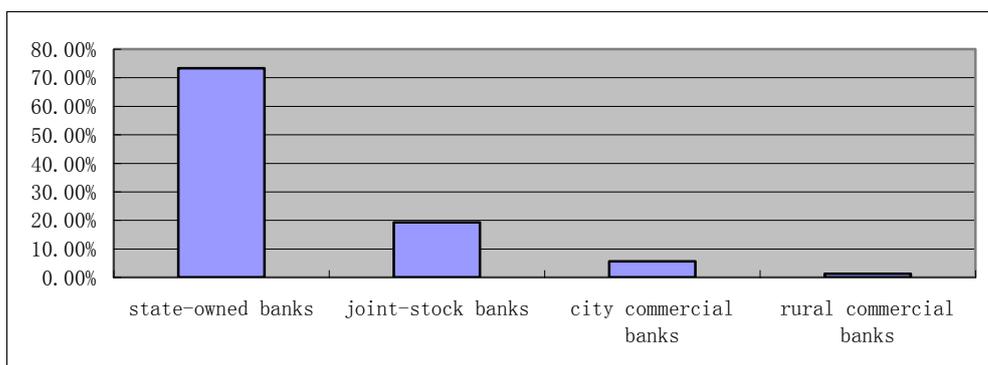
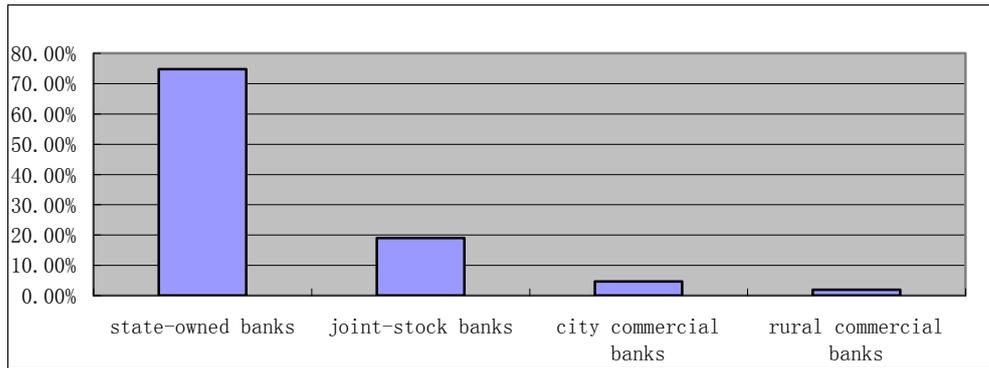


Table 3 Pre-tax profit %



Source: The Banker (2006)

The four state-owned banks are seemingly financial magnates in China. If we check the Banker's Top 100 Chinese Banks listing in 2008, the total pre-tax profit increased to RMB 570.5 billion. It increased 95.7% surprisingly. The most contribution came from the other 96 banks which increased almost three times, but the increase of four state-owned banks is only 55.9%. Maybe it implied us there is a shifting role in banking system of China, the assets of four big banks is also decreasing from 73.7% in 2007 to 68.3% in 2008. It makes sense if we appropriately understand the gap between city commercial banks and the magnates, even we could measure the gap is how large. This work is useful to give some suggestions for the further development of city commercial banks.

1.2 The constraints for development of city commercial banks

1.2.1 Regulations emphasize capital adequacy

Since the Basel Accord⁵ was signed in 1988, the venture capital⁶ became more and more important management concept and regulatory concept in international finance. The China Banking Regulatory Commission promulgated guidelines on capital

⁵ Basel Accord, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

⁶ Venture capital is a type of private equity capital typically provided to early-stage, high-potential, growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company.

adequacy for commercial banks in 2004. It demanded that the capital adequacy of all the commercial banks can be not less than 8% by 1st Jan 2007. It means that the bank must have 8 yuan in every 100 yuan of its asset. The guidelines also stated a method to divide three groups of commercial banks according to the capital adequacy, there are banks with sufficient capital, banks with insufficient capital and banks with severe insufficient capital. The classification takes advantages to take supervision measures correspondingly for CBRC. The supervision authority has right to take intervention measures in order to keep the capital adequacy of commercial banks reaches or exceeded the minimum supervision standard. The CBRC would take corrective action for the banks which are far behind requirement of capital adequacy, at the same time, the supervision authority has rights to ask the commercial banks to change senior managers. Meanwhile, the CBRC could takeover the banks or force the banks reorganized or and even dismiss banks by law if the banks are substantially backwards in capital adequacy. Therefore, China views the capital adequacy of commercial banks as the core index of supervision.

However, the higher requirement of capital adequacy is harder for city commercial banks than state-owned banks. Due to geographic limitation, the city commercial banks have small scale of assets from beginning as urban credit cooperatives. Compared with the national state-owned banks, they have greater business range and big scale of capital. Therefore, the state-owned banks have sufficient capital, city commercial banks usually fall into the group of banks with insufficient capital or severe insufficient capital. It cause more interventions from the China Banking Regulatory Commission. How to improve themselves in the new changing regulation environment? The city commercial banks should think about how to change the management model and profit growth pattern in order to raise profitability. However, only if city commercial banks accumulate and enhance their own capacity, they have an appeal of foreign investment so that a stable and effective long-term mechanism of supplementary capital could set up. In fact, the capital supplement is not the only goal, it is a necessary condition. The core target is to change the passive capital constraint

into active incentive mechanism.⁷ The city commercial banks need to think about enhancing investment value and ROAs of banks by changing profit pattern and business model.

1.2.2 Market competition makes great pressure

In the past years, the scale and amount of banking industry in China is increasing dramatically. The city commercial banks feel difficult to survive by the same business model and relatively simple income structure compared with state-owned banks. The four big banks are doing more and more business such as the international settlement, credit cards business more and intermediary service. What's more, as WTO accession, city commercial banks also face the competition with foreign banks which are allowed to engaging in more and more business. If mentioned about the financial products, the city commercial banks still lack of a clearer market positioning to develop more suitable products and more powerful comprehensive ability.

In addition, city commercial banks fall behind in risk management and liability management compared with big national banks. The supervision authority demands a higher level of liquidity management of commercial banks recent years, because the process of interest rate liberalization in China is speeding up⁸. It implies the commercial banks are allowed to discrimination pricing according to market risks. However, city commercial banks take disadvantages by only simplify relying on interest margin. As interest rate liberalization, the interest margin of savings deposits and loans is smaller. The four state-owned banks have a better model of intermediary business⁹; it is value added service with better profitability. It is worthy to notice that the supervision authority allowed banks to establish Fund Company¹⁰. Therefore, the

⁷ Xiao Qiang, Research on efficiency of city commercial banks. Financial Theory and Practice
ISSN:1003-4625.0.2007-03-002

⁸ Zhiyi Deng, The commercial banks should emphasize liquidity management[N], Financial News, Sep 12th, 2006

⁹ Keyong Han, Study on Development Strategie of Commercial Bank Intermediary Business in the New Period, Journal of Lanzhou Commercial College, 2008.2

¹⁰ An interview with Dr. Shusong Ba who is vice president of Development Research Center of the State Council about reform of banking sector by www.people.com.cn

state-owned commercial banks has opportunity to develop intermediary business further business step by step, such as asset-backed securitization, insurance service and wealth management service take advantage to improve profitability. Compared with city commercial banks still stay where they are.

1.2.3 Diversification of customer demand

In the four big banks, the diversification of service categories and income structure became a main trend, they are improving their capacity to provide wide range of financial products. In recent years, as China experienced economic growth in high speed, all the financial institutions began to focus on improvement their own financial management. What is more important, the cash management, custody administration and investment banking tend to be the hotspots in development of banking sector in China. Compared with city commercial banks feel hard to do personal business in local range, because many limitations such as long-distance settlement could not done by different cities or provinces. It narrows the target customer groups of city commercial banks.

As the Chinese economy grows, the market scale of personal business is expanding, at the same time; the urgent demand of individual customers drives bank services to be diversified. It is reasonable that the status of personal business would raise in short future. This trend has influence on the gap between city commercial banks and state-owned banks.

1.2.4 More bureaucracy in city commercial banks

In general, the corporate governance structure of China's banking sector is still following typical approval system; it is obviously that there are amounts of officials in every level of management. Even those commercial banks which are engaging in reform through stock system, they are used to be bureaucracy. Moreover, compared

with state-owned banks, the city commercial banks are more obviously bureaucracy because they have strong relationship with local government no matter before reform or now. In the past period, the urban credit cooperative plays a role as “local ministry of finance” which is more likely a branch of municipal government. It is controlled by administrative order directly including saving the local financial revenue for government or allocating loans for all projects as long as related with government. It is easily to keep bureaucracy for city commercial banks than state-owned banks, even nowadays the municipal governments still strive for some rights of city commercial banks.

1.2.5 Organizational procedure causes low efficiency

Because of close relationship with local government, if we check the organization flow of city commercial banks, it is easily found that the sub-branches in counties lack of enthusiasm. Owing to most employees of banks work in the sub-branches where have lower income than those work in head offices. In addition, the assessment system and incentive mechanism are not perfect which is difficult to get career promotion from the grass-root, it is natural to cause low efficiency in the institutions. All the branches of city commercial banks are under the judgment of head offices which means the head offices have right to made rules for establishing business categories or interest rate. It causes another constraints for city commercial banks of slow approval procedure, the sub branches gradually lose their spirits.

1.2.6 Lack of preferential policy

From the historical aspect, city commercial banks are supported by governments. Although there was exsiting game between them. On one hand, the local government hope city commercial banks is powerful to responsible of loans for public projects, on the other side, the government do not wish the city commercial banks are too powerful to lose their control by the mean of consolidation with other city commercial banks. In

this complex consideration, city commercial banks are hard to get preferential policy as state-owned banks or even can not compared with foreign banks. The constraint for city commercial banks mainly on unfair market access and tax policy.

According to the latest regulation of supervision commission, every single foreign shareholder could not hold above 20% of shares of domestic bank¹¹.however, there is an exception for private commercial banks, there is unfair for city commercial banks. because the private capital has no influence on big state-owned banks, however, they could not invest city commercial banks. In that case, the other private banks are easy to get investment compared with city commercial banks which are also urgent to improve their capital adequacy. In addition, city commercial banks are levied on different tax rate from foreign banks. All these policy factors constrain the development of city commercial banks.

2. How to measure the gap between city commercial banks and state-owned banks

Through the analysis above, I have a brief idea about the history and status-quo of city commercial banks in banking system of China, and I try to figure out some constraints including external and internal reasons to explain why there is a gap between city commercial banks and state-owned banks. In the next part which is also my research part, I try to do a rating system to measure the gap, it would be helpful for our understanding what are the advantages and disadvantages of city commercial banks and what strategies should be made for narrowing the gap.

2.1 References on rating system

¹¹ Supervision and management of dominant stockholders,published by China Banking Regulatory Commission,27th March 2008

In order to design a reasonable and scientific rating system to fulfill the target of this thesis, I do a lot of reviews on the rating system or indexes which are used by professional journals or previous study on how to compare the competitiveness of commercial banks.

2.1.1 ranking by professional journals

Firstly, there is a famous British professional financial magazine published by British Bankers' Association. It collects management indexes of commercial banks all around world. It has review on Top 1000 World Banks every year. The Banker uses a whole set of specialized indicator system which use the Tier 1 capital as main index, because the Tier 1 capital is accepted by public. Tier one capital is the most significant measurement of bank strength. The ranking can be viewed in it entirely or sorted by assets, country or region.

Second, the Euromoney is an excellent source of the worldwide capital markets. It has rating every year for the performance of commercial banks including profits, business innovation and so on. The rewards contain "Awards for excellence", "Best global investment bank". The Euromoney feel interesting in emerging market including Asia, Africa, Latin Africa and former Russia and Eastern Europe. According to the owner's equity at last year, the Eurimoney publishes report on Top 250 Banks in emerging market.

The third reference is Asiamoney. The Asiamoney provides discerning reports and analysis of financial and investment markets for capital issuers, borrowers, institutional investors and senior corporate and government monetary decision-makers with business interests in Asia-Pacific countries. It creates industry-recognized rankings include Broker's Poll, FX Poll, Cash Management Poll, Corporate Governance Poll,

Custody Poll and Best-Managed Company Poll.¹² In addition, Asiamoney do surveys in Asia-Pacific, Europe and America to report the Best Managed Companies and Executive in each Asian country and regions.

Fourth, Yazhou Zhoukan (YZZK) is a good refernce on how to do a ranking. The predecessor of YZZK is the Asiaweek, which is the first worldwide Chinese journal. It chooses key indicators to measure performance of twelve Asian countries to do the rankings for Top 300. The YZZK also have polls for the banks which got highest return on assets, the banks which got highest net profits, the banks which got most credits and the banks which made biggest loss and so on.

Fifth, China has a domestic financial magazine named the Banker, which chooses six indicators to measure actual competitiveness and another six indexes for measuring potential competitiveness. The ranking mainly relies on four state-owned banks and joint-stock commercial banks. Those indicators to measuring development of commercial banks are market share, scale of banking assets, quality of assets, liquidity management, profitability and degree of international. Another six indexes to measure potential development of commercial banks are human resource, technology, financial innovation capacity, corporate governance, internal control and service competency. It is noticed that the chosen indicators for rankings every year are changing.

2.1.2 The rating index used by IMD-WEF

After the introduction of how the professional journals to do ranking, I consult the rating index used by IMD-WEF briefly. The World Economic Forum and the Institute for Management Development use this assessment to the relationship between banking sector and national economy, and what is the influence of banking system on national

¹² Asiamoney since its launch in 1989 has been providing discerning reporting and analysis of the ins-and-outs of financial and investment markets for capital issuers, borrowers, institutional investors and senior corporate and government monetary decision-makers with business interests in Asia-Pacific countries.

development. It is a complete rating but more macro scope than my research question, I just emphasize the fourth category “efficiency of banking sector” which is helpful to construct my rating system.

The table below could reflect a brief idea about the system.

Table 4 IMD assessment system of financial competitiveness

Factors	Indicators
Capital cost	1.real interest rate in short-term 2.capital cost 3.international credit rating
Efficiency of capital market	4.financial standing...11.the proportion of international factoring and exported commodities
Stock market	12.raised fund in stock market...16.insider trading
efficiency of banking sector	17.the rate of adding interest 18.scale 19.the proportion of assets of banks and GDP 20.transparency of financial institution 21.confidence of financial transactions 22.financial technical personnel 23.educational background of finance 24.implement and enforcement of monetary policy of central bank 25.legal supervision of financial institutions 26.circulation of credit cards 27.credit cards transaction

Source: Statistics & Information Tribune 5th 2006

2.1.3 Previous works on how to compare the competitiveness of commercial banks

Since it is a hot topic, some domestic scholars did mass of researches on finding the gap between domestic banking sector and foreign banking sector, or between different ownership of commercial banks. I pick five researches to be references which are useful to construct a rating system measuring the gap between city commercial banks and state-owned banks of China

Jinpu Jiao¹³ (2002) launched his framework of rating system based on both practice and theory. His model was composed by four parts including current competitiveness, potential competitiveness, analysis of financial environment, quantitative analysis of competition situation of commercial banks. First, the current competitiveness means

¹³ Jinpu Jiao, comparison of Chinese banks competitiveness. China Financial Publishing House, 2002

the survival ability of a commercial bank; it is measured by several financial indexes including the market share, profitability, management level, quality of assets and capital adequacy. It could briefly reflect the situation of whole banking industry in China. Second, the potential competitiveness refers to those internal factors can effect future competitiveness of commercial banks, such as the organizational and management mechanism, innovation capacity, efficiency of regulation and supervision. These internal factors play vital role in follow-up effects. Third, the financial circumstance of China measures how external factors influence future competitiveness including macroeconomic environment, financial momentum and effects. Development of related industries also influences potential competitiveness. I think his analysis of how to design a framework is very useful for me to do the rating.

In another work, Zhimin Dai and Li Zhou study the gap between small and medium commercial banks of China. Their analysis framework show the evidences how the small and medium banks developed in foreign countries, they also have contributions to analyze specific ways for weakers to narrow this gap.¹⁴

In the research by Yuanxu Li (2000), he states that the comparison of state-owned banks, non state-owned banks and foreign banks is significant. The indicators are mainly relied on economic benefits, service capacity and capital safety. The research finds that the main reasons cause big gaps between three groups of banks are technology, human resource and mechanism of risk prevention. Based on his research result that different ownership categories for commercial banks have significant gaps, it has reasons to believe the gap between city commercial banks and state-owned banks is as big as my expectation.

In Bin Wen's opinion¹⁵, three factors which are representing of core competitiveness play vital role to be successful in banking sector. There are financial technology,

¹⁴ Li Zhou, Zhimin Dai. The competitiveness of small and medium commercial banks in China. China Social Sciences Press. 2003

¹⁵ Bin Wen, Core competitiveness of commercial banks. Studies of International Finance[J]2004,(4):58-64

organizational structure and human resource. Through his comparison of four state-owned banks, he found the core competitiveness of Industrial and Commercial Bank of China was E-service; the vital competitiveness of Construction Bank of China was comprehensive service. The key factor of Bank of China was foreign exchange business. However, the Agricultural Bank of China has blank in the core competitiveness.¹⁶ Actually, this is part of reason why I exclude the Agricultural Bank of China (ABC for short) in my comparison between city commercial banks and state-owned banks. If we check the development of ABC, it is controlled by central government more than other three state-owned banks because its function is allocate the loans for farming projects which are closely related with national agricultural policies. The evidence shows ABC is not listed commercial banks yet, which is exception of state-owned banks. It is hard to analyze its operation and management because it is difficult to collect data or useful materials.

At last, I consult the work by Chuiyong Chan and Hongqing Chen¹⁷. They designed a measurement system of competitiveness of commercial banks which composed by four “first-level indexes”, fourteen “second-level indexes” and thirty-five supplementary indexes. This system is comprehensive but also too complicated. According to these plentiful materials, I compare the advantages and disadvantages of each rating system. I choose CAMEL rating system which is more practical and more realistic to assess the gap between city commercial banks and state-owned banks.

2.2 Introduction of CAMEL rating system

The CAMELS Rating System is a set of institutional assessment indexes of credit standing and operation designed by American monetary authority. Because the beginning letter of five indexes are “Capital Adequacy” “Asset Quality”

¹⁶ Bin Wen, analysis of core competitiveness of four banks[J]The Banker,2004,(9):62-65.

¹⁷ Hongqing Chen,Chuiyong Zheng. Rating system of core competitiveness of commercial banks.Finance Teaching and Research.[J]2004,(5)

“Management” “Earnings” “Liquidity”. The CAMEL ratings are accepted by public owing to its efficiency. Based on CAMEL system, the international organizations add other indicators later including the assets quality, deposit structure, human resource, earning performance and capital adequacy. It proved that the framework of CAMEL is classical and used widely in banking area.

The CAMEL rating system divides the competitiveness of commercial banks into five levels. The specific indexes and reference values are below:

For capital adequacy, it is a proportion of capital and risk assets. It required that the rate at least reaches 6.5%-7%. For the rate of problem loans and capital, usually the proportion is less than 15% if the bank has good management and operation. For the third assessment, we need to consider the management level and staff qualification, in addition, how the bank to handle emergent events and decision of BOD is important. The banks need complete the inner control and perfect innovation for attracting customers. For the banks which the proportion of net profits and earning assets exceed 1% are in the first or second level. Those banks which the proportion of net profits and earning assets are between 0% and 1% are in the third and fourth level. However, if the banks have negative percentage, they are in the last rank. For the requirement of liquidity, the banks which meet the demand of deposit the money and granted a loan any time. It refers to the first of second level of good liquidity. The banks are in the third or fourth level if they obviously failed to allow the customer saving of granted a loan in any time.

Through five individual assessment, a comprehensive evaluation of CAMEL ranks the commercial banks at certain level. The features of CAMEL rating system are assessed by the single item, then the system get five indicators to be integration and work out the final result. At the same time, it combines qualitative analysis and quantitative analysis. The model focus on the ability of risk management and put other factors into consideration such as the scale of bank and financial risk. The result will provide clear

information about the performance of commercial banks.

3. Method

3.1 Data selection

Since the target of this paper is understanding the gap of city commercial banks and state-owned banks, I have to select limit but efficient data from the group of city commercial banks. Because there are more than one hundred city commercial banks in the China with different geography and scale. To avoid the selection bias, I choose two city commercial banks one is from the eastern part of China, Shanghai which is representing of the most developed city. The other one is from the western part of China, Guiyang city which is a typical developing city. As known, the distribution of economy volume and resources including the human resources and capital is uneven in China. The average development level of eastern part of China is better than mid-west.

Shanghai is the most dynamic economic and financial center which has the first Gross Domestic Production of China in 2008. The development of banking system of Shanghai is obviously better than other cities in China¹⁸. In the Lujiazui Forum 2009, Liu Mingkan who is the president of China's Bank Regulatory Commission stated that the modern financial market system which involved capital, currency, foreign exchange, commodities, financial futures, gold, transactions of property rights and reinsurance market already be formed in Shanghai. The CBRC will continue to support Shanghai to develop all financial projects in order to enlarge the scale of business. The international degree of banking in Shanghai is highest, the credit quality also is best in Shanghai. At the same time, the commercial banks in Shanghai attract most 60% of foreign investment. It is statistical that foreign financial institutions located in

¹⁸ Liu Mingkan, Shanghai has comparative advantages in banking industry. 10th May 2008. shanghai securities news

Shanghai reached 858 at end of 2007¹⁹. The banking contributed to Shanghai GDP exceeded double digits percentage. Compared with Guiyang, which ranks 101 for the GDP in 2008. The Guiyang Commercial Bank ranked 35 in Top 100 Chinese banks in 2007. The Tier 1 capital was 14.66 hundred million compared with 121.4 hundred million of Bank of Shanghai, the assets was 302.67 hundred million far behind of 2700.43 hundred million of Bank of Shanghai.²⁰ The difference between Shanghai and Guiyang is significant. In this case, the two city commercial banks from Shanghai and Guiyang should be typical representatives.

In another group of state-owned banks, as we known, there are four members in this group. However, the ABC has not listed yet and it is influenced by the policies to have a relatively fluctuation on its performance. For example, the non-performing loan ratio is 23.57% in 2007, but it decreased to 4.3% dramatically. It is supported by the People's Bank of China by paying the bad loans. What's more, the important index to measuring financial performance of ABC is unpublished. Therefore, I choose the other three state-owned banks as the representatives for the other group.

However, there is a problem with data that the annual report of three state-owned banks are in time. Either the annual report of 2008 or the first quarterly report of 2009 can be found in the official websites. In contrast, the financial data about the city commercial banks are not timely. Guiyang commercial bank only has the annual report of 2007 as the latest published financial report. Owing to the data, I have to do the financial analysis on the basis of annual reports of 2007.

3.2 Process of CAMEL rating system

I used the ICBC for short of Industrial and Commercial Bank of China, CCB is for

¹⁹ China Yearbook 2007

²⁰ The data is from the Annual Report of the Bank of Shanghai and Guiyang Commercial Bank of 2007.

short of China Construction Bank, BOC is for short of the Bank of China. BS used for Bank of Shanghai and GCB is short for Guiyang commercial bank.

I begin with the single evaluation of five indicators which contains capital adequacy, assets quality, management, earning and liquidity. I use tables below to output the result directly which could compare the difference between city commercial banks and state-owned banks easily.

Firstly, Table 5 shows that comparison of Capital adequacy of city commercial banks and state-owned banks. It is a ratio of total capital and total assets. The total capital includes fundamental capital and long-term subordinated debts. The fundamental capital including equity capital, earnings, undistributed profits and loan loss reserve. According to reviews of a lot of professional journals and previous study, I pick up three financial items from annual reports of commercial banks, they are “capital adequacy ratio”, ”total equity to total assets” and ”total equity to total loans”.

Table 5 Rating of Capital adequacy

	Index	Formula	ICBC	CCB	BOC	BS	GCB
1	Capital adequacy ratio ²¹	(Tier 1 capital + Tier 2 capital) /risk weighted assets ²²	13.09%	12.58%	13.34%	11.27%	9.8%
2	Total equity to total assets	equity/total assets	6.27%	6.4%	7.08%	4.78%	5.51%
3	Total equity to total loans	equity/total loans and advances to customers	13.36%	12.87%	14.9%	9.86%	10.1%

The table 5 shows that the capital adequacy of city commercial banks averagely is weaker than the state-owned banks. However, the gap is smaller than before. As

²¹Calculated in accordance with the guidelines issued by the CBRC and the consolidated financial statements prepared in accordance with the PRC GAAP.

²² The balances of risk-weighted assets include 12.5 times of the market risk capital.

appreciation of BMB²³, the stock shares of city commercial banks become hotspots to attract investments so that the channels of supplementary capital are richer than before. It is good for development of city commercial banks. A report on competitiveness of city commercial banks²⁴ indicated that in average, at the end of 2007 the capital adequacy of city commercial banks increased to 9.79%. There are 95 city commercial banks reach the requirement of 8% in capital adequacy, 53 banks even reach 10%. The evidences demonstrate that the gap of capital adequacy between city commercial banks and state-owned banks is narrowing.

Second, this part is comparison of assets quality which means quantitative analysis of the quantity of risk assets, the preparation of loans, abundance of loan loss reserve, the staff quality and probability of non-performing loans.

Combined with the annual reports of five commercial banks, there are three indicators selected to describe the assets quality, the evaluation as below:

Table 6 Rating of assets quality

	Index	Formula	ICBC	CCB	BOC	BS	GCB
1	Non-performing loan ratio	Non-performing loan/total loans	2.74%	2.6%	3.12%	2.41%	6.06%
2	Allowances to non-performing loans	reserves for NPL/non-performing loan	103.5%	104.41%	108.18%	107.72%	50.5%
3	Allowances to total loans	Reserves for NPL/total loans	2.84%	2.72%	3.37%	2.6%	3.06%

The table shows that the assets quality of city commercial banks is behind the level of state-owned banks, but the best city commercial bank such as Bank of Shanghai is able to compete against state-owned banks. At same time, it demonstrates that the gap

²³ RMB is the Chinese currency.

²⁴The report on competitiveness of city commercial banks in China 2006~2007. The Banker,9th 2007

between Bank of Shanghai and Guiyang Commercial Bank is significant. Their performance is not similar even both of them are city commercial banks.

Next, the third indicator of CAMEL rating system is management, which is the most difficult measurement to do a quantitative analysis. The Management indicator assesses the bank policies, business plan, manager experience and training for employees. There are four indexes to describe the management of commercial banks, the internal control is totally qualitative data which collects from surveys. Table 7 gives the result of rating of management of city commercial banks and state-owned banks.

Table 7 Rating of management

	Index	Formula	ICBC	CCB	BOC	BS	GCB
1	Shareholder concentration ¹	Number of share by biggest shareholder/total shares	35.3%	67.97% ²⁵	67.49%	15.09%	22.29%
2	Shareholder concentration ²	Share hold by the biggest shareholder/share hold by second biggest shareholder	2.694%	4.898%	8.18%	1.886%	3.78%
3	ROIC ²⁶ of average past three years	Average of (net profit/net capital) in past three years	13.36%	10.93%	11.86%	19.6%	10.01%
4	Internal control ²⁷		A	A	A	B	C

From this table, it is reasonable that management level is decided by ownership structure to certain extent. The efficiency of management will be influenced by too high or too low shareholder concentration. The biggest shareholders of state-owned banks are all state-owned companies, such as Huijin Company owned 59.12% of CCB and the Jianyin which is a wholly owned subsidiary of Huijin owned 8.85% CCB. That

²⁵ Huijin directly and indirectly owned 67.97% of the issued share capital of the Bank as at 31 December 2007. "Huijin" is China SAFE Investments Limited

²⁶ ROIC is a financial measure that quantifies how well a company generates cash flow relative to the capital it has invested in its business.

²⁷ The report on competitiveness of city commercial banks in China 2006~2007. The Banker, 9th 2007

is high concentration degree which has advantage for the big shareholder to supervise the operation, on the other side, it has disadvantage for the efficiency of internal control. However, the diversification of shareholder of city commercial banks in current stage takes advantage of development compared with the city commercial banks are wholly controlled by the local governments before.

Fourth, earning is a key element to measure the gap between city commercial banks and state-owned banks. As we known, city commercial banks usually have geographic limitation which is hard to compete with national banks. No matter the business range or customer quantity, the state-owned banks have advantages in earnings. Therefore, this index is helpful for quantitative analysis how much is this gap.

There are two relevant financial indexes to be choosed. The return on assets (ROA) percentage shows how profitable a company's assets are in generating revenue. The Return on Equity (ROE) measures the rate of return on the ownership interest of the common stock owners. It measures a bank's efficiency at generating profits from every unit of shareholders' equity. ROE shows how well a commercial bank uses investment funds to generate earnings growth.

Table 8 rating of earnings

	Index	Formula	ICBC	CCB	BOC	BS	GCB
1	Return on average assets	Net profit/average assets	1.01%	1.15%	1.09%	0.95%	0.55%
2	Return on average equity	Net profit/average equity	15.14%	19.5%	14.22%	19.88%	9.98%

The table demonstrates that the earnings of state-owned banks are better than the city commercial banks. The Bank of Shanghai as the best city commercial bank, has a smaller gap with state-owned banks compared with Guiyang Commercial Bank which

is merely half earning ability of state-owned banks. Because city commercial banks which are located in the eastern part and coastal part of China obviously have greater profitability than the city commercial banks which are located in the mid-west part. The data shows that the average ROA of city commercial banks which are located in Yangtze River Delta region reached 0.92%²⁸. The evidence supports there is relationship between financial structure and economic development inevitably. It reflects that the high profitability partly owing to eastern economy structure. Some previous study also gives us theoretical support, such as Patrick, H.T. (1966)²⁹, Raymond W. Goldsmith (1969)³⁰, Levine and Ross (1997)³¹. They demonstrated there is a positive relationship between economic structure and banking sector more or less. It could explain the difference within the group of city commercial banks, for example, the better performance in Shanghai and backwardness of Guiyang. I will provide the explanations why the economic structure differs performance of banking sector more detailed in next part. It is helpful to understand the difference of city commercial banks and they should take appropriate strategies according to practice and precondition.

According to a report, it shows that 29 city commercial banks have ROA larger than 1%, is improving fast compared that only 1 city commercial bank has ROA larger than 1% in 2002³². It demonstrates that the development of city commercial banks is very fast and the gap with state-owned banks is tend to be narrow. The average ROE of all city commercial banks was 0.33% in 2002, but it increased to 0.7% in 2006, which increased twice. In summary, the profitability of city commercial bank is improving fast.

²⁸The report on competitiveness of city commercial banks in China 2006~2007. The Banker,9th 2007

²⁹ Patrick, H.T. (1966), "Financial development and economic growth in underdeveloped countries", *Economic Development and Cultural Change*, January, pp.174-87.

³⁰ Raymond W. Goldsmith. Financial structure and development. New Haven, Yale University Press, 1969.

³¹ Levine, Ross, 1997. "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature*

³² The report on competitiveness of city commercial banks in China 2006~2007. The Banker,9th 2007

The last indicator of CAMEL system is liquidity. The index observes the change of bank deposit. It reflects dependence degree of borrowed funds, at the same time, it also reflects the quantity of circulating assets.

From five annual reports of state-owned banks and city commercial banks, the liquidity ratio and loan-to-deposit ratio are choosed to make a comparison.

Table 9 The rating of liquidity

	Index	Formula	ICBC	CCB	BOC	BS	GCB
1	Liquidity ratio ³³	current assets to current liabilities	26.8%	43.5%	32.6%	26.9%	40.67%
2	Loan-to-deposit ratio	Loan to deposit	56.3%	61.27%	64%	61.37%	56.74%

The table shows that the gap of state-owned banks and city commercial banks is not significant in liquidity. Therefore, the state-owned banks have no advantages in liquidity. To another word, the city commercial banks catch up with the ability to meet obligations when they come due without incurring unacceptable losses.

After the five individual assessment, we have a brief idea about the gap between city commercial banks and state-owned banks. The city commercial banks are not laggards in every assessment. It is possible that city commercial banks take their own advantages to decreasing the gap. On the basis of table5 to table9, I will change the percentage of each commercial bank into a grade refers to the mark and criterion researched by the China Merchants Bank. The table 10 shows the output clearly.

³³ The above liquidity ratios are calculated in accordance with the formula promulgated by the China Banking Regulatory Commission.

Table 10 Grades of city commercial banks and state-owned banks

	Indicators	marks	Criterion	ICBC	CCB	BOC	BS	GCB
Capital adequacy	Capital adequacy ratio ³⁴	50	If the ratio is 8% get 6p, if the ratio is more than 8% get 6p every 1%	36	30	36	24	12
	Total equity to total assets	30	If the ratio is 2% get 6p, if the ratio is more than 2% get 4p every 0.5%	38	38	46	26	34
	Total equity to total loans	20	If the ratio is 4% get 6p, if the ratio is more than 4% get 2p every 0.5%	22	21	25	15	16
	Total			96	89	107	65	62
Assets quality	Non-performing loan ratio	40	If the ratio is 15% get 4p, if the ratio is less than 15% get 4p every 1.5%	36	36	32	36	28
	Allowances to non-performing loans	30	If the ratio is 40% get 4p, if the ratio is more than 40% get 4p every 10%	28	28	28	28	8
	Allowances to total loans	30	If the ratio is 2% get 4p, if the ratio is more than 2% get 3p every 0.3%	10	10	16	10	13
	Total	100		74	74	76	74	49
Management	ROIC of average past three years	25	If the ratio is 10% get 3p, if more than 10% get 2p every 1%	9	3	5	21	3
	Internal control	25	A-25 B-20 C-15	25	25	25	20	15

³⁴ Calculated in accordance with the guidelines issued by the CBRC and the consolidated financial statements prepared in accordance with the PRC GAAP

	Shareholder concentration1	25	If the ratio is between 17% and 25% get 25p, if deferent with the level subtract 1p every 1%	15	0	0	23	25
	Shareholder concentration2	25	If the ratio is times of 3 get 25p,the difference of every 0.1% subtract 1p	22	7	17	14	18
	Total			71	35	47	78	61
Earnings	Return on average assets	50	If the ratio is 0.3% get 3p, if more than 0.3% get 2p every 0.05%	31	37	33	29	13
	Return on average equity	50	If the ratio is 10% get 5p,if more than 10% get 2.5p every 2%	10	15	10	15	5
	Total	100		41	52	43	44	18
Liquidity	Liquidity ratio	50	If the ratio is 25% get 3p, if more than 25% get 2p every 1%	5	39	17	5	33
	Loan-to-deposit ratio	50	If the ratio is 75% get 3p,if less than 75% get 2p every 1%	37	19	23	19	37
	Total	100		42	58	40	24	70

Because I choose the average weighted method in CAMEL rating system. Table 11 shows the result of final assessment adding the 20% to each indicator.

Table 11 Final assessment of rating system

			ICBC		CCB		BOC		BS		GCB	
	Index	weight	mark	value								
1	Capital adequacy	20%	96	19.2	89	17.8	107	21.4	65	13	62	12.4
2	Assets quality	20%	74	14.8	74	14.8	76	15.2	74	14.8	49	9.8
3	Management	20%	71	14.2	35	7	47	9.4	78	15.6	61	12.2
4	Earning	20%	41	8.2	52	10.4	43	8.6	44	8.8	18	3.6
5	Liquidity	20%	42	8.4	58	11.6	40	8	24	4.8	70	14
	Total	100%		64.8		61.6		62.6		57		52

4. Conclusion

From Table 11, it is concluded the three state-owned banks are leading compared with city commercial banks. They are definitely financial magnates in China. It is admitted that there is a gap between state-owned banks and city commercial banks as my expectation. The city commercial banks as the greatest numbers of financial institutions in China, they play a vital role in providing financial service to local small and medium enterprises. In this case, they need to take strategies to improve their performance which is related with the performance of whole banking sector of China. However, there is also a gap within the group of city commercial banks. Although they have similar historical background, reform process and ownership structure, they have difference such as Shanghai and Guiyang. It reminds us it is complicated to considering the relationship between financial development and economic growth. When we design blueprint for city commercial bank, we should not only consider its comprehensive management and competitiveness, but also we should think about how to coordinate with local economy development.

We could from a theoretical aspect to explore why the city commercial banks in Shanghai and Guiyang have different development. Let us begin with the concept of

financial structure³⁵ which is announced by Goldsmith in the work of “financial structure and development”. He hold a popular point that the financial structure plays a significant role in economic development and growth (Goldsmith, 1969; Mckinnon, 1973; Stiglitz, 1985). They agreed that three aspects could prove financial structure have positive influence on economic growth. First, Goldsmith claimed that the change of financial structure would induce financial development which induce the upgrade of financial structure inevitably. Therefore, there is reaction between financial structure and financial development. Second, in the work of H.Patrick, he observed good financial structure would accelerate economic growth through his model. Third, if we use a model to describe the reactions between financial structure, financial development and economic growth. We will find this reaction could promote developement of finance and economy together by using the economic growth as a intermediary. It could be written by “financial development-economic growth-upgrade of financial structure to optimized”, ”upgrade of financial structure to optimized-economic growth-financial development”. In summary, the city commercial banks are under different financial structures in China. If we design strategies for their development, the relationship between local finance and local economy should be taken into consideration.

5. Strategies for city commercial banks

5.1 Local government should support banking reorganization

It is a practical strategy if the city commercial banks could be reorganized successfully, the banking union can not only have a common share all the resources, but also take advantage in settlement than before. At that time, the city commercial banks could decrease the total cost but create more competitiveness.

³⁵ Financial structure,

However, the organization of city commercial banks can not easy to carry into effect. The main pressure is from local government. With a respect of history, the form of city commercial banks is to decline the financial risk of urban credit cooperate and sustain the local economy. At the beginning of city commercial banks, the ministry of finance divides the boundary of city commercial banks according to provinces or cities, then local government get different budget fund from central government. What's more important, the central government set a rule that the maximum of local government's share is 30%, the max share of single enterprises is 10%, and the personal shareholder could not exceed 2%. Therefore, local government became the most interference of city commercial banks.

The governments located in eastern or coastal part of China less constrain the city commercial banks as sources of fund. Due to more abundant economic resources aggregated in big economy volume such as Shanghai, there is only one city commercial bank in the municipality. However, the backwards province such as Guizhou province³⁶, according to scope of jurisdiction, there are several city commercial banks such as Guiyang city commercial bank, Zunyi³⁷ city commercial bank. As the government there lacks of sources of fund, to some extent, the city commercial banks are second "ministry of finance" for the government. In addition, the scale of bank and management ability has a big gap even they locate in the same province. The combination is hard.

Owing to the role of local government is important for the development of city commercial banks, it is urgent to change the relationship between these two. The data from the State Council Development Research Centre, almost all the management level of city commercial banks are appointed by government directly. Even in some city commercial banks, the principal of BOD and management are the same. It is against the articles of the business law and corporation law.

³⁶ Guizhou province had GDP of 2543 00million in 2007, which is rating at the 26th of 31 provinces and areas in China. Source: Institute of Finance and Trade Economics, Chinese Academy of Social Sciences.

³⁷ Zunyi City is the important secondary city of Guizhou Province, with GDP of 667 00million in 2008.

Although the reorganization and combination is tough work, but there is a trend for developing of city commercial banks. Local government should research how to solve the problems of manager appointment, revenue sharing, approval procedure. The experts said as the process of combination of city commercial banks, they should insist on taking the market as the orientation.

A case of successful combination of city commercial banks happened in Jiangsu province in 2006. Ten city commercial banks abolished separate legal personality and set up unified legal personality. The total obligatory relationships leave for the new bank. The head office set up in the capital of Jiangsu province which including related administration sections and branches. All the participated city commercial banks are authorities to elect for director of each bank, and then the new combination commission is organized by those directors. They signed an agreement of unified calculation. Nowadays, the development of Bank of Jiangsu is rather better than the other city commercial banks. The data shows that at the end of first year that it has combination and reorganization, the increase rate of assets of Bank of Jiangsu reached 19.9%.³⁸ Thanks to the shared market, human resource and all resources, city commercial banks find a way to enhance competitiveness effectively through combination. Local government should shift the role and keep up with the trend and demand of market. It is expected that the policy interference will be eliminate soon.

5.2 Privatization of local commercial banks

The research by Institute of Finance and Banking, Chinese Academy of Social Sciences³⁹ stated that financial ecology consists of local government, economy and judicial. The financial ecology⁴⁰ play key role in financial assets quality. The

³⁸ The annual report of Bank of Jiangsu 2007

³⁹ Li Yang, local government should improve financial ecology. & report on the financial ecology of cities. Institute of Finance and Banking Chinese Academy of Social Sciences

⁴⁰ Nuojin Xu, Analysis on financial ecology of China. Institute of Finance and Banking Chinese Academy of

development of city commercial banks could comply with this rule and explore a suitable case.

The city commercial banks were held by certain shares of private economy but developed very fast. The privatization of city commercial banks is an advanced strategy. What's more important, this change is following the trend of economy model in Zhejiang province.

The private economy in Zhejiang province takes an important position in industry. A big group of small and medium private enterprises has economic vitality but they have great difficulty with financing from the state-owned financial institutions. There are two reasons that first; the state-owned financial institutions have discrimination on the development of private economy which is small scale and more risk than the state-owned companies. On the other side, the main target of state-owned banks is not private economy. It is reasonable they do not spend so much on researching the small and medium private enterprises. The information asymmetry causes a problem of financing from state-owned banks.

In the early stage of private economy, the urgent financing demand of private enterprises was satisfied by venture capital and circulating funds provided by underground finance and informal financing institutions. This financing model brought itself huge financial risk so that the supervision authority supported the private economy to participate in the local banking sector. In addition, there is no limitation of how many private shares in a bank. The further goal of local regulatory authority is clear that privatization of city commercial banks would be the best strategy.

Nowadays the development of private city commercial banks and urban credit cooperatives is favorable. It is related to the appropriate positioning of these small and medium banks that they mainly serve the demand of small business not the big state-owned enterprises. On one side, these city commercial banks were held by the private economy which is weak to compete with four state-owned banks for SOEs. It is

decided by the different property rights. On the other side, the target customer of state-owned banks usually some projects involves hundred billion yuan. To decrease cost, the positioning of service for private economy is more reasonable. Moreover, the city commercial banks and private enterprises have similar scale, which has similar development condition with community banks in US. It is effective way to solve the information asymmetry.

Taizhou commercial bank is representing of successful city commercial bank in Zhejiang province. As transition of modern banking system, Taizhou commercial bank combined the traditional unincorporated bank and modern banking practice. It set up the business in 1988 with only six employees and capital fund was merely hundred thousand. Now, Taizhou commercial bank developed very fast, it has registered capital of 900 million yuan and 1800 employees. As the expansion, it has 43 business establishments. This private bank is exploring its own banking system which is with efficiency according to its understanding of this regional economy. It has basic rule that it does best to meet the demand of customer but never deal with large enterprises, never do the mortgage of house and vehicle. Until the first half of 2009, the bank lend the total loan is 241 billion yuan which is strong support of local small and medium enterprises. The data shows that there are 39.9 thousand customers lending and average amount of loans is 412 thousand which is pretty lower than other banks.⁴¹ It is admitted that the method of Taizhou commercial banks deserve to be learned by other city commercial banks which located in secondary cities. Nowadays, more and more private capitals flow into city commercial banks in Zhejiang province. This model is accepted by public because it works efficiently.

Another case is Jiangxi province which has huge private capital and high rate of folk financing. The leading industry there is mining. The data indicated until 2004 there is at least 2500 billion yuan of available private capital to be invested.⁴² However, the

⁴¹ Annual reprot of Taizhou commercial bank 2008

⁴² In 2005, Pacific Economic Cooperation Council which is a network of member committees composed of individuals and institutions dedicated to promoting cooperation across the Asia Pacific region, do the research of Jiangxi economy.

mass funds flow into other provinces, part of them goes to provincial commercial banks, part of them put in the real-estate. Compared with the loss of local capital, masses of small and medium enterprises in Shangxi province face the crisis of financing problem. In this year, Jinshang Bank which is reorganized on the basis of Taiyuan city commercial bank set up. Jinshang Bank attracts great amount of funds to improve the financing problems of local industries at the same time, it is a good way to use the mass local private capital. Based on the purpose, it is expected that the performance of Jinshang Bank would be competitiveness.

5.3 Grasp the opportunity to foreign capital

To meet the demand of capital adequacy, the city commercial banks are allowed to absorb foreign investment. Take Bank of Shanghai into an example, it is the earliest case for city commercial bank to attract foreign investment. In Sep of 1999, inter national Finance Corporation, which is one of the subsidiary of the World Bank obtained 5% share of the Bank of Shanghai. In 2000, the Bank of Shanghai got foreign investment again from The HSBC and Shanghai commercial bank⁴³.

The aim of foreign institutions is to open the market which the economy is better developed than the other parts of China. Undoubtly, the high-end customer of every city is their target. In addition, the scale of city commercial banks is moderate. Some city commercial banks have good assets quality so that these banks are favored by foreign investors.

For city commercial banks, they need fund to improve the capital adequacy, what's important; the foreign investment could bring advanced management concept, financial technology and financial products. On the other side, the foreign investment will cause diversification of

⁴³ It is different from Shanghai city commercial Bank which is located in Hongkong.
<http://www.shacombank.com.hk/>

equity stake. As above introduction, the city commercial banks are controlled by the local government or local powerful SOEs. After the foreign fund injection, the governance of bank gains benefits and efficiency could be improved. Take Bank of Nanjing as example, it is the second city commercial bank of China to accept the foreign fund. The International Finance Corporate became the third biggest shareholder which takes 15% of Bank of Nanjing.⁴⁴ After the equity injection, International Finance Corporate raise capital by their high reputation all around the world, moreover, they dispatch a group of international financial experts to train the employees in Nanjing. It is obviously an effective way to enhance competitiveness of commercial banks.

For the foreign institutions, as WTO-accession they are eager to enter into this market. The ambition investor know the position of four state-owned banks, the power of four banks have potential to be the first rank commercial banks of world. Considering the high cost and reality of financial system, the foreign investor prefers to buy a share of city commercial banks. Not only they could share local resources such as customers, but also the foreign financial institution has chance to expand their business in other area.

Since the high speed development of invested city commercial banks, more and more foreign financial institutions claimed that China should raise the maximum share of foreign shareholders. Once the city commercial banks are allowed to be listed, the equity stake will add. And the foreign investor definitely is a winner.

5.4 Cross-district operation and restructuring

The Bank of Shanghai was the first city commercial bank to be permitted to open its business in other provinces in 2006. It provided a good example that successfully cross-district operation and restructuring. At the same year, the branch of Ningbo (Zhejiang Province) opened business. The Nanjing branch (Jiangsu province) and the

⁴⁴ The Bank of Nanjing. <http://www.njcb.com.cn/>

Hangzhou (Zhejiang province) start their business in 2007 and 2008 respectively. This breakthrough makes great sense because it is first time to break the limitation of local government. Cross-district operation take advantage in compete between banks. In addition, the development of city commercial banks integrates with international practice and complied with international trend.

Why the cross-district operations improve the competitiveness of city commercial banks? Owing to the traditional business of city commercial banks was limited to savings deposits and loans which belong to settlement. The main income structure is single and it is obviously a weakness compared with the bigger scale and more braches of four State-owned banks. The direct consequence of competition is great loss of profits and revenues.

In addition, the other powerful competitor is joint-stock commercial banks. They do not have to afford the pressure came from single stock ownership compared with state-owned banks. Therefore, they were born to comply with operation model and internal management mechanism of modern commercial banks. Not only it standardized enterprise behavior, it has clear property right and strong constraint force. Although they do not get the government subsidiaries, they are not obliged to do policy-related loan. The government intervention of joint-stock commercial banks is obviously less than city commercial banks. As the only goal is to survive and pursuing profit maximization, the high degree of mercerization strengthens its competence.

The city commercial banks must go far to enhance their competitiveness. Take the Bank of Beijing as example, which is the first city commercial bank according to the Tier 1 capital. The vice president of the Bank of Beijing pointed that the cross-district operation took advantage in improving the assets structure, which embodied the company business and personal business had chance to expand. In recent years, it already set branches in Tianjin, Shanghai, Xi'an, Shenzhen and Hangzhou, Xu said the cross-district development proved that the city commercial bank have ability of assets

management, risk management and business configuration⁴⁵. The Bank of Beijing only dispatch presidents of each branch, the other resources are localization.

He also figured that cross-district operation could enhance the resistant ability of risk. For instance, the leading industry of one city is high pollution industry, in the demand of strict controlling of pollution, the local enterprises are influenced and so the city commercial banks are. If the bank was limited in one area, it had impact enormously.

In summary, the city commercial banks are allowed to go to another province or city, indeed more and more banks are engaging in expanding its business. However, the cross-district operation has some challenges. First, the corporate legal person management system and risk management is difficult to plant to other cities. What's important, whether the soft factors such as the management concept and enterprise culture could be planted to new branches is the most challenge.

6 Source

6.1 Official yearbooks

There are lots of official yearbooks are helpful to know the macroeconomic environment. For example, the GDP and population of certain city in China is available. Also I find the details about the local financial institutions so that I could gain a brief idea about the development of local economy and the competition whether is tight. Due to the data this paper widely used is all in 2007, so the China Yearbook 2007, Almanac of China's Finance and Banking, China City Statistical Yearbook 2007 are vital to give a macroeconomic back ground of this topic.

⁴⁵ Ningyue Xu who is the vice president of Bank of Beijing. The interview "We are engaging in services for small and medium enterprises" in Central University of Finance and Economics 2008

6.2 Financial reports reported by each commercial banks

In the four state-owned banks, there is only Agricultural Bank of China is not lists. The annual report of ABC is hard to collect, so in the comparison group, I delete this bank and choose the other three state-owned banks as comparison with the city commercial banks. The annual reports of these banks are necessary. On the basis of correct and detailed data, the analysis could make sense.

6.3 Questionnaire by professional institutes

In China, there are some professional institutes doing research on the commercial banks. Some are profitable in the purpose of business, but some are research by the government and supervision such as Insitute of Finance and Banking, Chinese Academy of Social Sciences. The quality and reality of questionnaire is outstanding for analyzing.

6.4 Interviews with the managers of commercial banks

It is hard for me to make appointments with the managers of these banks, but the interviews hold by the mass media is available. For example, the Shanghai security news which is located in the financial and economic centres of China, and have access to handle the latest materials and latest financial policy. At the same time, the mass media also is a channel for shareholders of commercial banks.

7 Some problems

1. The data is not perfect, and the source channels are limit. The data is mainly from the Yearbook, survey and financial report published by each banks. The financial report could be found from the listed joint-commercial banks only. This is a small range of listed banks in the hundred of city commercial banks of China.

The data is time-delay. Although the Yearbook collected the data of last year, but it takes long time to wait for the final statistical result. For example, the deadline for collect data is 30th September or 31st Dec in 2008. But the official Yearbook 2008 comes out at least later than April of 2009. I found the financial report on the official website of Bank of Shanghai, the latest report is until half year of 2008, it means the whole statistic result of 2008 has not finished, at least it does not published. But the latest data published in Guiyang Commercial Bank's website is before 2008.

Compared with city commercial banks, the four state-owned banks already published the annual report of 2008 even the first quarterly report of 2009. The annual reports of each bank lack of unity to be compared. Therefore, I have to choose the same time to do the research. That is the reason why the data is somewhat old.

The financial data are collected by different statistical agent and different schedule. It causes troubles sometime. When I failed of looking for the annual report of 2008 of Guiyang commercial bank, I found one of categories of "The annual report of People's Bank of China 2008" is "The balance sheet of city commercial banks 2008"⁴⁶. The data with good validity need to be regularly in time and the collection needs to be unified by the same financial institution.

2. The quality of annual reports is not guaranteed. The quality and reality of data determined the estimate of economic performance directly, but the reports are provided by the banks themselves. I have no ability to distinguish and verify all these data, but this is a fact that the annual report is not true completely.

⁴⁶ The annual report of People's Bank of China 2008, Page 76

On one side, the quality of annual report is decided by the quality of management. The better corporate governance structure improves the reality. As for the external environment, the auditing law and related law influence the quality of annual report.

On the other side, the supervision is hard to stop the fake annual reports completely. The connected transactions are the most difficult to regulation and the easiest way to profit manipulation. As the annual report must be published, making up a profitable annual report is a common way to handle with requirement of financial transparency. In addition, the items in annual report are quite easy to distort. For instance, accounts receivable, accounts payable and assets depreciation reserves. Some experts⁴⁷ point out that some listed companies would reduce the depreciation in the item of assets depreciation reserves in order to emphasize the profits. It is possible that the listed companies could do the fake annual report through many channels⁴⁸.

3. In the process of CAMEL rating system, there are some indicators of subjective judgment. The survey based on interviews and investigations which is not quantitative analysis. However, there is a question, if I interview with a manager of Construction Bank of China, it is hard for him to judge the management level or corporate governance of CBC frankly, what's more difficult, how does he to comment on the other banks. Therefore, the necessity of the survey is doubtful. What does it make sense for ranking? I have to say the rating model has certain limitation.

4. My paper is not just for comparison of city commercial banks. Most city commercial banks are still limited in one city although the regulation and law have provided the fair market-access environment. Only a few city commercial banks with better performance, such as Bank of Shanghai open business in new province or city. Moreover, each city commercial bank has own advantages and disadvantages. That is

⁴⁷ Xingqiang Du, Yu Lei. The Influence of Corporate Performance and Auditing Opinion on Timeliness of Corporate Annual Reports. Finance and Trade Research. 1st 2009.

⁴⁸ Xingqiang Du. The Relevance of Accounting Information: Some Analyses from the Perspective of Accounting Standards. Contemporary Finance & Economics. 10th 2008.

why some scholar discuss that there is not a competition relationship between the city commercial banks.⁴⁹

This paper is for understanding the gap between city commercial banks and state-owned banks. In our image, the gap is existing for a long time, but how large is large, could it be changed. Through the quantitative analysis, the conclusion is the performance of city commercial banks is weaker than state-owned banks from capital adequacy, assets quality, management, earnings and liquidity. However, the gap is narrowing, the city commercial banks are expected to be stronger to compete with the state-owned banks. In this case, the whole banking sector of China would be improved by competition, at that time, the financial market is not only the games of four financial magnates. At last, the paper pointed out the development of city commercial banks need appropriate strategies which are coordinated with its own local economic growth. It provides four strategies based on case study in order to narrowing the gap with state-owned banks.

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