Scepticism needed in China's banking frenzy

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The initial public offering of the Industrial and Commercial Bank of China is poised to become the largest in history. The investor enthusiasm is puzzling because, in spite of the IPO, the Chinese government will still be ICBC's majority owner.

Many investors discount government control because the government has financed the removal of losses resulting from past lending policies, encouraged ICBC and the other large banks to accept foreign investors and facilitated the sale of small amounts of the banks' equity to the public. These moves all indicate a sophisticated awareness of the incentive structures required in modern efficient banks.

Yet the lesson from international experience is that public-sector banks perform poorly by the usual market metrics: returns on equity are low, expenses high and they are dogged by non-performing loans. The reason to expect the same in China is that social stability is an overriding policy objective. More than 700m people reside in rural areas where incomes are one-third of those in urban areas. Social stability depends on financing enough jobs to absorb new entrants, lay-offs and migrants. There is abundant evidence that the government still relies on the major banks for this funding.

One indicator is China's unsustainable investment growth rate. The banks' role in this is critical. Their mainstay borrowers are companies, most of which are still directly or indirectly government-controlled. As the large banks' own published financial statements show, corporate customers still account for between 70 and 80 per cent of their loans. In 2005, roughly 40 per cent of the industrial state-owned enterprises (SOEs) were losing money and current data indicate their losses continue to mount. The largest SOEs are reporting burgeoning profits and, no doubt, financing new investments themselves, but they are the exceptions: in 2005, the 10 largest accounted for more than 53 per cent of total SOE revenues and the 165 SOEs owned by the central government for more than 70 per cent of profits. The implication is that banks' exposures are likely to be greater to the thousands of smaller government-dominated firms whose profits appear to be much less certain.

Richard Podpiera, an International Monetary Fund researcher, found that the large state-owned banks were losing market share to other financial institutions more quickly in those provinces that contained the most profitable customers. Instead, the banks seem to be lending wherever the SOEs need money. For instance, in 2003 and 2004, across provinces, there is a near perfect correlation between the share of bank loans to SOEs and government shares of industrial production. Data on loan pricing patterns at the banks since 2004 show that the interest rates charged to borrowers are compressed around the benchmark rate and show little pricing for risk. Such tendencies suggest these banks will be inefficient low-margin, low-growth businesses that will lose out to smaller banks that are better able to modernise themselves without attracting political opposition.

As their uncommercial lending continues, we expect the largest banks to need another bail-out. By most calculations, a bail-out would be affordable. If those loans publicly reported by the big three as at risk of becoming non-performing turn bad in 2007, there will be an estimated Rmb1,500bn of new bad loans from lending during the current boom; amounting to about 7.2 per cent of 2007 gross domestic product.

While affordable, another bail-out will divert public funds from other priorities such as enhancing public services in rural areas and accelerating urbanisation. To reduce the probabilities of further calls on the public purse, the largest banks could be structured differently. One option would be to organise them into a "good bank" and "bad bank" structure that separates new assets and customers from bad assets and customers: the good bank has clear incentives to grow and the bad bank to wind down lending.

Another alternative is the "narrow bank" model, which confines the banks to investing depositors' assets in low-risk government securities. Unless the government's goal of efficient banks is better reconciled with its political goal of social stability, the prospects for these newly listed companies are limited.

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