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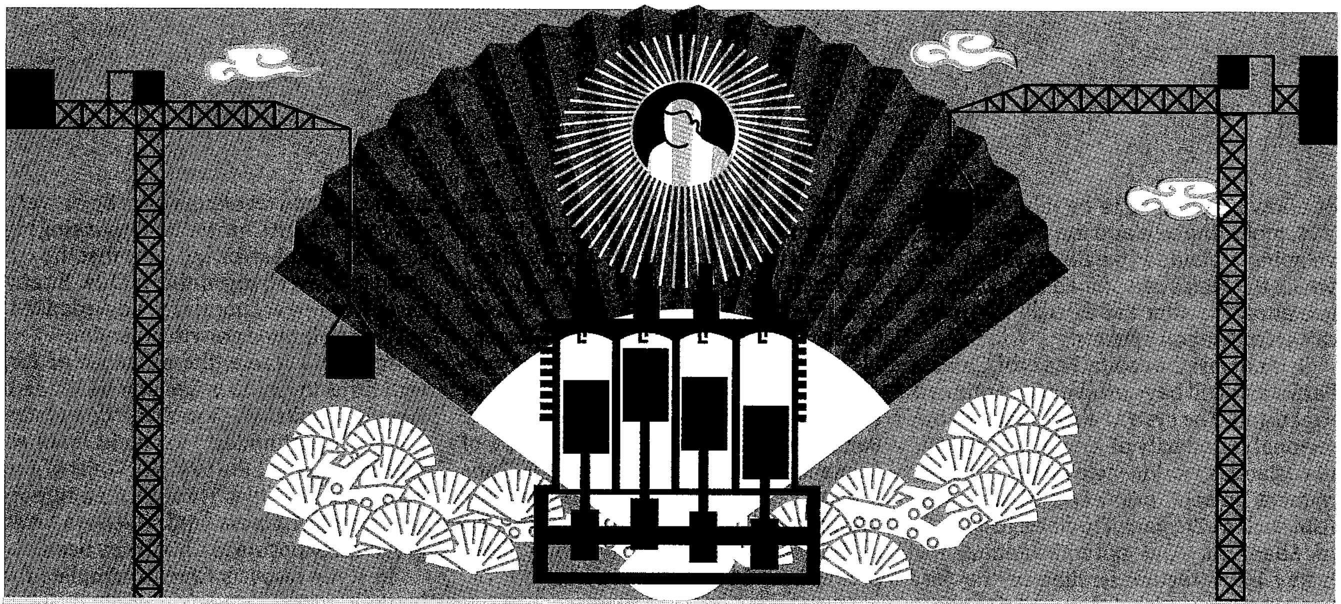

Domestic duties

CCB, China's second-biggest bank, exemplifies the size of the task at home

IT IS something of a surprise to find that the bank boss with the best line in deadpan humour is Guo Shuqing, chairman of China Construction Bank (CCB). When it floated in Hong Kong in 2005 Mr Guo reminded the assembled ranks of slick investment bankers and analysts that during the Cultural Revolution he had been a cowboy. Five years on the bank has risen to be the world's second-largest by market value, after ICBC. Over that period its profits have more than doubled to $16 billion, more than at any of America's three most profitable banks, JPMorgan, Wells Fargo and Goldman Sachs.

CCB embodies the paradox of many emerging-market banks. It is huge and has grown phenomenally quickly, but the demands placed on it at home are also huge. Last year it expanded its loan book by 27%. The industry as a whole grew even faster, by 32%, partly thanks to the leading role the banks played in the government's economic stimulus. New loans made in China were equivalent to almost a third of GDP. Roy Ramos, an analyst at Goldman Sachs, points out that in less than ten months China added the equivalent of India's banking industry twice over.

The government is now working hard to ensure that the lending spree does not cause a bad-debt problem that infects the banks (which it had to recapitalise just under a decade ago). In April Liu Mingkang, the top banking regulator, said he had asked the banks to submit "comprehensive" reviews of their loan books by June. Of particular concern are the infrastructure projects backed by local governments, which accounted for perhaps a third of the new loans. These projects often suffer from poor cashflow, no explicit guarantee from the state and limited transparency.

Mr Guo is optimistic about bad debts in the banking system overall. "If we deal cautiously with this risk we will have a soft landing," he says. However, he also cautions that there is no blanket guarantee for local infrastructure projects: "Not all can be rescued by the central government." The key, he reckons, is to improve the flow of cash to local authorities, which itself requires further reforms. The cap on the amount of bonds the central government issues on their behalf needs to be raised. But China also needs to "open the front door" by allowing local governments to raise municipal bonds. At the same time the government can enlist the help of China's remaining fully state-owned banks, although their role needs to be defined clearly to avoid moral hazard. The same goes for the plethora of smaller local banks that can be encouraged to provide more credit to local projects but must, he says, remain "independent institutions".

Hungry for capital

China's banks are highly profitable, which gives them a buffer to absorb potential losses. Still, in response to the rapid growth in loans and the risk of bad debts, the banks are also busy raising capital. Bank of China, Bank of Communications and ICBC have indicated that between them they will issue up to $28 billion-worth of new securities, bolstering their core capital by about a seventh. CCB has yet to finalise its plans but it is likely to issue new equity too. Agricultural Bank of China, a giant fully state-owned lender, is considering floating a minority of its shares on the Shanghai and Hong Kong stockmarkets this year.

China's banks have a lot on their plates right now, thanks to the lending surge of the past two years. But even in the medium term the industry is likely to be quite a challenge to manage. Part of this relates to capital. This year, for example, the government is still aiming for lending growth of about 19%. At the same time China's banks are paying hefty dividends, limiting the amount of capital they generate internally. Mr Guo at CCB, which paid out 44% of profits last year, explains that "according to international practice the ratio should be about 30%." But an absolute dividend cut is unlikely because Huijin, the state vehicle that owns stakes in the banks, needs the income to pay interest on the funds it spent recapitalising China's banks back in 2003. Although the planned capital-raising may dilute Huijin's stake, currently at 57%, the government has "got some room", Mr Guo says, to maintain a majority shareholding.

Other banks agree that more capital will be required over time. Yang Kaisheng, the president of ICBC, said recently that the big four banks could need $70 billion of outside capital over the next five years—about double the maximum they have indicated they might raise now. This was assuming loan growth of 15% a year. At some point the state will need to inject more capital into the banks or permit them to cut their dividend payouts. The third option, ▸

of allowing its stake to be diluted below 50%, looks unlikely, and the fourth, of developing a shadow banking system into which the banks can offload assets, seems less attractive after the debacle in America's securitisation markets.

It is not just the capital bases of China's banks that will have to adapt to continued expansion. The system already has all the regional complexity of America, from Hainan Island, a Florida-style property-development hotspot, to pockets of conservatism such as Zhejiang Province, just south of Shanghai. And notwithstanding the heavy infrastructure lending of the past two years, the mix of the banks' lending will shift. Today only a fifth of all loans are to households. But as saving declines, consumer lending, including mortgages, will become more important. At the same time rapidly developing capital markets will offer big companies an alternative way to raise money and put pressure on banks' lending margins. Mr Guo reckons that lending to consumers and small firms could rise to 40% of CCB's loan book within five years, from about a quarter today.

If China's banking system and its capital markets develop as planned, it will be one of the biggest and fastest financial transformations ever seen. If they do not, the result may be one of the world's bigger financial headaches. There is little inclination to allow a sudden influx of foreign banks that might make the system less stable. Chinese banking has interacted with the outside world cautiously, lagging the expansion of China's big industrial firms. Bank of China last year generated 22% of its pre-tax profits outside mainland China but most of this was from Hong Kong and Macau. ICBC, which has shown the most expansionist instincts, derived only 4% of profits from abroad.

No adventures

Mr Guo, for his part, advocates caution abroad. Using domestic deposits to fund purchases of foreign assets involves too much risk: "If the currency were to appreciate, how would we pay it back?" CCB made 1% of its profits from abroad last year but the idea of boosting this by buying equity stakes in foreign banks is not enticing: "We don't want to do that very much...we want to establish a network abroad for our customers but their requirements are limited." Mr Guo says Western politicians and regulators have been "very nervous" about Chinese lenders taking big stakes in their banks, but adds that the crisis may have changed this a little. In any case, Western economies are overbanked, suggesting limited growth potential.

In mirror image, the influence of foreign firms in China is likely to be limited. Western banks, Mr Guo says, "don't have many opportunities" to build enough branches to rival the vast networks of the big domestic banks. Through their minority stakes in Chinese banks Western firms get all the exposure to China they need.

In some respects China's template for banking seems rather conservative. It envisages a stable industry structure, with limited entry for Western newcomers, a high degree of government co-ordination and a cautious view of banks going abroad. Yet at the same time it is dynamic, with vigorous competition among domestic banks, big shifts in the pattern of lending, plenty of product innovation and, most important of all, fast credit growth. This kind of "managed finance" model is no longer confined to China. Since the crisis a milder version of it has gained fans all over the emerging world. ■