Private Banks in China: Origin, Challenges and Regulatory Implications

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1. INTRODUCTION

China continues with its financial reform on several fronts. Most recently, it started to encourage domestic investors to establish privately funded commercial banks. It is perceived as the largest change in China's state-dominated banking sector in recent years. The state ownership in China's banking industry, which distinguishes it from its western counterparts, reflects the remains of the old-fashioned centrally planned economy which was implemented in China for several decades in the second half of the 20th century. Since China started its market-oriented economic reform in the late 1970s, the planned economy system has been gradually abolished. Currently, the market discipline, or "the invisible hand", plays an increasingly important role in the world's second largest economy, but the state monopoly still exists in some key industries such as banking, telecommunication and energy.

The main purpose of encouraging private investors to set up new banks is to solve the long-lasting problem of financing difficulties faced by China's private enterprises, particularly small and medium-sized enterprises ("SMEs"). After the 37-year economic reform, SMEs now generate nearly 60% of China's economic outputs and provide majority of the new jobs in China, but in contrast, they only receive a fifth of the total bank loans.[1] This is because China's state-run lenders still have a strong preference for making loans to other state-owned enterprises ("SOEs"), and are reluctant to provide credits to privately-owned firms. As a result, money-starved entrepreneurs have no choice but to borrow heavily from China's shadow banking system, at an expensive cost, to fund their business ventures. Such a heavy reliance on underground lenders has led to a series of credit crises in recent years, which has created systemic risks to the Chinese financial system and has destabilised China's real economy.

In response to this, in 2014 the Chinese government initiated a reform to allow qualified private capitals to launch privately funded banks in order to breakup the state monopoly in the sluggish banking sector, as well as to provide more available credit for the capital-strapped enterprises.[2] From 2015, until now,

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1 Emma Dong & Simon Rabinovitch, "China's lending laboratory" *Financial Times* (23 May 2012) 11.

2 Jamil Anderlini, "China opens door to private banks" *Financial Times* (11 March 2014)

five new pilot banks have been launched, while more than ten proposed banks are waiting for the approval of China's Banking Regulatory Commission, the banking "watchdog". Hopefully, these new banks can bring competition to the state-dominated banking arena in order to create efficiency, and to alleviate the financing dilemmas of the SMEs.

This article focuses on the latest financial reform in China concerning privately funded banks. It will briefly introduce China's state-owned banking sector, followed by the SMEs' financing problems and the recent shadow-banking crisis. Next, it will look into pilot private banks being established at the moment, and analyse potential challenges encountered by those new lenders. Finally, some regulatory changes in the banking sector will be evaluated, and a conclusion will be drawn.

2. THE STATUS QUO OF CHINA'S BANKING SECTOR

At present, the major players in China's banking industry include the "big four", which refers to the four largest state-owned banks in China (the "Big Four"), a dozen national joint-equity commercial banks, and hundreds of city commercial banks. Compared to their Western rivals, Chinese banks have remained intact from the recent global financial crisis, and have become the most valuable and profitable banks in the world. The Big Four include the Industrial and Commercial Bank of China ("ICBC"), the China Construction Bank ("CCB"), the Agricultural Bank of China ("ABC") and the Bank of China ("BOC"). They are already the largest lenders in the world in terms of their market capitalisations and total assets, and of the top 10 banks in a global bank ranking, they take up 4 positions.[3] However, despite China having thousands of deposit-taking institutions, its banking assets are relatively concentrated in the hands of a few large lenders. In 2014, the Big Four along with the Bank of Communication, which is the fifth largest lender in China, possess 41.21 per cent of total banking assets.[4] All of the Big Four are publicly listed on the Shanghai and Hong Kong stock exchanges, which means domestic and foreign investors can trade their shares freely. However, China's central government still exerts firm controls over these banks' business operations, since the state is their majority shareholder via its investment arm, Central Huijin Investment Ltd. Currently, China's state council owns more than 60 per cent of stakes in each of the Big Four. In practice, the Chairmen and CEOs of the Big Four, who are

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online: ft.com <http://www.ft.com/cms/s/0/7096239e-a8e0-11e3-bf0c-00144feab7-de.html> [*Anderlini*].

3 "World's Largest Banks 2015", online: Relbank <http://www.relbanks.com/worlds-top-banks/market-cap>.

4 Financial Stability Analysis Group of the People's Bank of China, *China Financial Stability Report 2015* (Financial Stability) at 37, online: Pbc.gov.cn <http://www.pbc.gov.cn/english/130736/2946072/2015090616281480816.pdf> [*Stability Report*].

appointed by the central government, enjoy vice-ministerial administrative powers and therefore are often perceived as government officials rather than real bankers.

Next to the Big Four, there are nearly a dozen joint-equity commercial banks, such as China Merchants Bank, China Everbright Bank and Shanghai Pudong Development Bank. They are large lenders, operating nationwide, and most of them are public companies. Generally speaking, joint-stock banks are smaller than the Big Four in terms of size, but healthier in terms of asset quality and profitability. Similarly, these banks also have strong government backgrounds, as most of them were firstly initiated by local governments. The only exception among national banks is the China Minsheng Bank, which was established in 1996 by a group of private investors. Until recently, the China Minsheng Bank has been the only fully privately-owned bank in China. Despite being privately owned, it is still subject to strict government oversights as its senior personnel have to be approved by the Communist party.[5]

In addition to the Big Four and the joint-equity commercial banks, there are 133 city commercial banks operating in the banking business within specific regions, most of which are based on former urban credit cooperatives. Clearly, the local commercial banks have strong ties to local authorities that previously provided funding for local banking businesses. In addition to these major national and urban lenders, China has 665 rural commercial banks, 89 rural cooperative banks, 1,596 rural credit cooperatives and 1,153 rural village banks.[6]

In summary, the common denominator of the Chinese banks is their close relationships with China's central or local governments. The Big Four and other commercial banks have been long viewed as "policy-oriented" commercial banks as they are subject to heavy political influence and state intervention.[7] It is evident that as the regulator, the shareholder, the financier, the businessman, the guarantor and the employer, the state plays multiple roles in China's banking industry.[8] Apart from the conflict of interests, many drawbacks can be observed in the state-run banking model. It is widely criticised for low efficiency and poor service, since Chinese lenders can make huge profits without putting in a lot of effort by taking advantage of their monopoly status and favourable policy supports. Moreover, as a significant proportion of bank loans have been granted to SOEs or their financing vehicles, which often invest in large-scale infrastructure projects, the high number of bad loans will always remain a serious concern for Chinese regulators.[9] Undoubtedly, the state-dominated

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5 *Anderlini*, *supra* note 2.

6 *Stability Report, supra* note 4 at 38.

7 Shen Wei, "Healthy or Unhealthy? That is a Problem — Unveiling the Myth of Chinese Banks' Success" (2013) 2 Journal of International Banking Law and Regulation 81-88 [*Shen*].

8 Violaine Cousin, *Banking in China,* 2d ed. (Palgrave MacMillan 2011) at 56-57.

9 *Shen*, *supra* note 7.

banking industry has had many negative impacts on the national economy, but here we will limit our attention to the financial difficulty faced by millions of Chinese SMEs which have restricted access to credit.

3. THE FINANCING DILEMMA OF CHINESE SMEs

The financing difficulty of SMEs has been a universal issue of great importance, which is encountered not only by entrepreneurs in developed countries but also by those in emerging economies.[10] In spite of their great contributions to global economic growth and recovery after the recent financial crisis, SMEs worldwide often receive inadequate credits from formal financial institutions. Apparently, SMEs are more dependent on domestic bank lending than large corporations, as they have limited financing methods other than bank loans.[11] In the European Union, around 99 per cent of all non-financial companies are SMEs, creating 58 per cent of value added and 66 per cent of total jobs.[12] However, after the global financial crisis, new bank lending to those SMEs in the euro zone fell by 35 per cent between 2008 and 2013.[13] In Britain, there are approximately 4.5 million SMEs which make up 99.9 per cent of all businesses and which are responsible for over half of private sector employment and nearly half of all private sector turnover. Nonetheless, the lending towards British SMEs has also been declining since the financial crisis.[14]

In China, the financial situation of SMEs is even worse than their European counterparts. Although Chinese SMEs produce nearly 60 per cent of the Gross Domestic Product ("GDP") and create 80 per cent of the total jobs, they only obtain 20 per cent of the total bank loans.[15] This is because China's banking sector is filled with state-owned lenders, who are unwilling to lend to private businesses.[16] Although a small portion of the banks' credit is reserved for small firms by the order of the government, most of state-owned banks give a lot of priority to other well-connected SOEs when they lend money.[17]

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10 See e.g. Gert Wehinger, "SMEs and the credit crunch: Current financing difficulties, policy measures and a review of literature" (2013) 2013/2 OECD Journal: Financial Market Trends 1, online: oecd.org <https://www.oecd.org/finance/SMEs-Credit-Crunch-Financing-Difficulties.pdf>.

11 *Ibid.*

12 "Financing Europe's small firms: Don't bank on the banks" *The Economist* (16 August 2014) online: economist.com <http://www.economist.com/news/finance-and-economics/21612251-small-businesses-seek-alternatives-banks-leave-them-lurch-dont-bank>.

13 *Ibid.*

14 BIS, "SME Access to External Finance" (2012) 16 BIS Economics Paper.

15 Emma Dong and Simon Rabinovitch, "China's lending laboratory" *Financial Times* (23 May 2012) 11 online: ft.com <http://www.ft.com/intl/cms/s/0/90e7f67a-a41b-11e1-a701-00144feabdc0.html#axzz43lFoNkgY>.

16 Andrew Moody & Hu Haiyan, "Banking woes mount for SMEs" *ChinaDaily* (5 December 2014) online: chinadailyasia.com <http://epaper.chinadailyasia.com/asia-weekly/article-3703.html>.

As a result of this, Chinese SMEs, refused by mainstream banks, have to borrow money from back-alley banks, which are often professional moneylenders or informal money houses, to fund their business operations. Currently, in order to raise capital many business ventures in China have to rely on informal financing or private lending.[18] According to Credit Suisse, an international financial services firm, the total value of outstanding loans in China's informal lending market amounted to 4 trillion yuan (US$644.8 billion) in 2012.[19] The private lending industry has been perceived as a vital element of the Chinese shadow banking system. The Financial Stability Board described the shadow banking as "the credit intermediation involving entities and activities outside the regular banking system".[20]

In addition to the huge loan demand from Chinese SMEs, the accumulation of private wealth in China supplies adequate funding for the rampant moneylending industry. In fact, Chinese individual investors, compared with their counterparts in developed countries, have limited investment choices due to the underdeveloped capital markets in China. Chinese residents are well known for being loyal savers due to the fact that the saving rate in China, or the saving to income ratio, normally stands at 40 per cent, which is the highest level in the world.[21] However, the real interest rate for bank savings has been negative for a long time due to inflation, namely, Chinese depositors are losing money on every yuan they put in their bank accounts.[22] Consequently, Chinese investors who have a lot of savings have been looking for new investments that can bring them higher returns, and private lending, which is able to generate considerable interest, has become a popular investment alternative for the Chinese.[23]

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17 "Shadow Banking in China: The Wenzhou Experiment" *The Economist* (7 April 2012) online: economist.com <http://www.economist.com/node/21552228>.

18 See Jianjun Li & Sara Hsu, *Informal Finance in China: American and Chinese Perspectives* (Oxford: Oxford University Press 2009).

19 Credit Suisse, "China: Shadow Banking — Road to Heightened Risks" Economic Research" (22 February 2013) at 2 online: <https://doc.research-and-analytics.csfb.-com/docView?language=ENG&format=PDF&document_id=1010517251&sour-ce_id=emcmt&serialid=VLRQ4TgNxWzk%2fTvHinuua2HrCBNc0syIwcysIn-vEMe0%3d>.

20 "Shadow Banking: Scoping the Issues" Financial Stability Board (12 April 2011) at 1 online: fsb.org <http://www.fsb.org/2011/04/shadow-banking-scoping-the-issues/>.

21 "China's Economy: Coming Down to Earth" *The Economist* (18 April 2015) at 19 online: economist.com <http://www.economist.com/news/briefing/21648567-chinese-growth-losing-altitude-will-it-be-soft-or-hard-landing-coming-down-earth> [*China's Economy*].

22 "Eating Bitterness in China's Financial System" *Wall Street Journal* (18 March 2011) online: wsj.com <http://blogs.wsj.com/chinarealtime/2011/03/18/eating-bitterness-in-china%E2%80%99s-financial-system/>.

23 The return of investing in moneylending is around 20% per year. (Data source: Wenzhou Private Finance Index online: wzpfi.gov.cn <http://www.wzpfi.gov.cn/>). It is much higher than the saving rate provided by Chinese banks. For instance, the benchmark rate

Moreover, as China's economy has gradually slowed down in recent years, an increasing number of industrialists who used to be exporters or manufacturers tried to diversify their businesses, and many of them invested in the money lending business. Furthermore, even some state-owned groups that have abundant cash reserves tried to take part in the moneylending by making loans to other cash-negative enterprises in order to gain higher profits.[24]

Hence, the money demand from capital-starved entrepreneurs and the money supply from wealthy savers and capitalists have contributed to the prosperity of China's shadow banking system. According to the *Economist*, a businessman from Wenzhou, a famous commercial city in East China, described the prevalent situation of underground financing in his city by stating that 100,000 people in Wenzhou are capable of raising one billion yuan (US$161.2 million) within 48 hours.[25]

4. THE SHADOW BANKING CRISIS

For a long time, China's shadow banking system was a win-win situation for both SMEs and underground lenders. After China started its market-oriented reform in 1978, and until 2012, the country witnessed an unprecedented economic growth driven by the rapid expansion of private economy, evidenced by an average of 9.8 per cent annual GDP growth.[26] Therefore, by utilising private lending most entrepreneurs have acquired enough capital for their businesses and accordingly benefited from the fast growth of the Chinese economy. At that time, the high cost of borrowing private loans could be easily offset by the huge profits generated from prosperous businesses. On the other hand, lenders also enjoyed considerably high returns on their investments compared to bank savings.

However, after the global financial crisis, things have changed completely. Although China was not hit directly by the financial "tsunami", its export-based economic system suffered greatly due to weaker demand from the rest of the world. China's GDP growth for the first quarter of 2015 was reported to be merely 7 per cent, the lowest since the start of the financial crisis.[27] In addition to declining exporting businesses, China's decade-long property market boom,

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for one-year fix-term saving is merely 1.50%. (Data source: People's Bank of China, 24 October 2015 online: pbc.gov.cn <http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/125440/125838/125888/2968982/index.html>.)

24 Shen Wei, "Shadow Banking System in China — Origin, Uniqueness and Governmental Response" (2013) 1 Journal of International Banking Law and Regulation 20-26.

25 "Entrepreneurship in China: Let a Million Flowers Bloom" *The Economist* (10 March 2011) online: ecomonist.com <http://www.economist.com/node/18330120>.

26 "35 Years, Chinese Economy Keep Rising" *People's Daily* (21 November 2013) at 4.

27 "China's first-quarter growth slowest in six years at 7%" *The Wall Street Journal* (15 April 2015) online: wsg.com <http://www.wsj.com/articles/china-first-quarter-growth-slowest-in-six-years-at-7-1429064535>.

which accounts for approximately 20 per cent of its economic growth, recently came to a halt as the housing prices fell by 6 per cent compared to the previous year.[28] Due to poor economic conditions, there was an increase in defaults in the private lending market as many entrepreneurs could not repay excessive interests charged by moneylenders, and faced insolvency caused by the lack of cash flows.

As a result, China has experienced a huge wave of lending credit crunches and corporate insolvencies in many parts of the country. In 2011, Wenzhou became the first Chinese city to encounter a serious financial crisis caused by its shadow banking system. At that time, a large number of local entrepreneurs tried to flee the city to evade debts and one-fifth of the city's 360,000 private businesses stopped operation and became insolvent.[29] On the list of the fugitive bosses are a number of high-profile entrepreneurs, such as Mr. Hu Fulin, chairman of the Zhejiang Centre Group, a top eyewear company in China.[30] Between August 2011 and May 2012, the municipal court system in Wenzhou dealt with 22,000 civil cases related to private lending disputes, with a combined monetary value of approximately 21 billion yuan (US$3.39 billion).[31] After the lending crunch in Wenzhou, the rest of China also saw the shadow banking crisis including default waves, failed businesses, and absconded bosses. For example, Mr. Ding Hui, who used to be the chairman and CEO of Fujian Nuoqi Co Ltd, China's well-known cloth maker listed on the Hong Kong stock exchange, suddenly disappeared in July 2014, and its share price slumped by more than 50 per cent in three consecutive days.[32] The reason for Mr. Ding's disappearance is his debt of nearly 1.5 billion yuan (US$242 million) owed to private lenders which he used to fund the expansion of his cloth stores in the pre-IPO period.[33] After a series of private lending crises, the Chinese government started to realise the severity of the systemic risk in China's rampant underground lending markets, worth trillions of yuan, as well as the great financial pressures faced by millions of Chinese privately-owned businesses, which made the government determined to implement reforms.

5. THE RISE OF PRIVATE BANKS

In order to solve the financial dilemma faced by the Chinese SMEs, and breakup the state monopoly in the banking sector, the Chinese government has

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28 *China's Economy*, *supra* note 21 at 17.

29 "Fears Surface over Chinese Debt amid Lending Practices" *BBC News* (6 October 2011) online: bbc.com <http://www.bbc.co.uk/news/business-15194663>.

30 "China's Economy: Hitting the Kerb" *The Economist* (22 October 2011) online: economist.com <http://www.economist.com/node/21533412>.

31 "Before and after the 'Wenzhou Private Financing Regulation'" *China Economic Weekly* (9 December 2013) at 58.

32 "Nuoqi's share slumping reason: chairman Ding Hui missing" *Xinhua* (26 July 2014) online: <http://news.xinhuanet.com/fortune/2014-07/26/c_126799805.htm>.

33 *Ibid.*

initiated a series of financial reforms, which began in 2013. In November 2013, the ruling Communist Party of China held an important meeting, the third plenary session of the party's 18th central committee meeting, where it passed a resolution to strengthen the social and economic reforms.[34] As one of a dozen reform tasks, it asked the current government to allow qualified private capital to set up new banks. As a result, in 2014 the Chinese government launched a pilot project to establish five new banks owned entirely by private investors in Shanghai, Tianjin, Zhejiang and Guangdong.[35] Following that, in the government working report 2015, China's Premier, Mr. Li Keqiang, confirmed the government's determination to move ahead with financial reforms, stating "We will encourage qualified private investors to establish, in accordance with the law, small and medium-sized banks and other financial institutions; there will be no quota imposed on them, and approval will be granted as long as all required conditions are met."[36] Clearly, the Premier's words demonstrated the government's determination to boost private banks and to inject more liquidity into China's private economy.

Consequently, the strong support from the government has led to the emergence of private banks in China. In 2015, the first five pilot banks have obtained banking licences and opened for business. Moreover, more than ten proposed banks are waiting for the approval from the banking regulator, the China Banking Regulatory Commission ("CBRC"). Here we will take a closer look at the five latest private banks in China.

In January 2015, the opening of the WeBank, the first privately-owned lender established in the past decade, attracted a lot of media attentions.[37] WeBank is a joint venture launched by Tencent, China's internet giant which takes up 30 per cent of the new bank's stake.[38] WeBank was named after Tencent's star product WeChat, a popular messaging app on Android and Apple smartphones. The registered capital of WeBank is 3 billion yuan (US$483.3 million).[39] To many people's surprise, the first privately-owned bank launched this year is an online-only bank with no brick-and-mortar presence. The business model of WeBank is similar to that of the Ally Bank in the United States or the

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34 Tom Mitchell, "Xi's four-point plan gives reason for optimism" *Financial Times* (15 November 2013) online: <http://www.ft.com/intl/cms/s/0/4469ec2c-4e06-11e3-8fa5-00144feabdc0.html>.

35 *Anderlini*, *supra* note 2.

36 Li Keqiang, "*Government Work Report 2015*" *National People's Congress* (5 March 2015).

37 Gabriel Wildau, "China's First Online-only Lender Launched" *Financial Times* (06 January 2015) at 16 [*Wildau*].

38 "Tencent ready to launch China's first private internet bank, WeBank" *South China Morning Post* (29 December 2014) online: scmp.com <http://www.scmp.com/news/china-insider/article/1670474/tencent-ready-launch-chinas-first-private-internet-bank-webank>.

39 *Ibid.*

Atom Bank in the United Kingdom, which do not have physical branches and can only be accessed via their websites or through mobile apps.[40] WeBank mainly targets Internet users, most of whom are personal consumers or small businesses that are not eligible for traditional bank loans. The operation of this kind of high-tech bank relies heavily on the latest information technologies such as face recognition and big data that allow the lender to carry out credit rating and identity verification online.

Premier Li Keqiang was invited to Shenzhen city, a Special Economic Zone in China where the Tencent group is based, to make a keynote speech for WeBank's opening ceremony.[41] He expressed Chinese government's resolution to accelerate the banking reform in order to bring real benefits for SMEs and the Chinese economy. During his speech, Mr. Li praised the WeBank for pushing forward the current reform, stating "It's one small step for WeBank, one giant step for financial reform."[42]

Following the WeBank, the Shanghai Huarui Bank was the second privately funded bank that opened for business this year. This bank was registered in the Shanghai Free-Trade Zone, which is another pilot project in China, with 3 billion yuan (US$483.3 million) worth of capital. According to the Shanghai office of CBRC, Huarui Bank is able to conduct a full range of banking services including deposits, lending, bankcards, foreign exchange and bonds.[43] The new lender's main promoters are two private conglomerates, the cloth-making giant Metersbonwe and the Junyao Group, who own 15 per cent and 30 per cent of the new lender's shares, respectively.[44] Huarui Bank's target clients are SMEs within the free-trade zone, so the proposed banking service is mainly for the purpose of trade financing.

Wenzhou Minshang Bank is the third privately-owned commercial bank to start operating in 2015, with registered capital of 2 billion yuan (US$322.2 million).[45] The city of Wenzhou has been perceived as the entrepreneurship hub in China, as it has an extremely prosperous private economy, but the local state-owned banks have never been able to satisfy the financing needs of its booming private businesses. Therefore, when Wenzhou's entrepreneurs have to raise funds, they often borrow money from local moneylenders at an expensive cost. According to one estimate, Wenzhou's shadow banking system amounted to 110 billion yuan (US$17.72 billion) in 2010, equivalent to 38 per cent of the city's

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40 "Banking on it: Taking your money off the high street" *BBC News* (6 March 2015) online: bbc.co.uk <http://www.bbc.co.uk/news/business-31735979>.

41 *Wildau*, *supra* note 37.

42 *Ibid.*

43 Feng Jianmin, "Shanghai's 1st Private Bank Starts" *Shanghai Daily* (29 January 2015) A10.

44 *Ibid.*

45 "Wenzhou Minshang Bank Officially Opened" *Xinhua* (26 March 2015) online: xinhuanet.com <http://news.xinhuanet.com/fortune/2015-03/26/c_1114773816.htm>.

GDP.[46] As a result, the launch of the Minshang Bank was warmly welcomed by the local business community as the bank will mostly provide financial services for SMEs in Wenzhou, a market that is heavily underserved by the state-owned lenders.

The fourth private lender established this year is called the Tianjin KinCheng Bank. Similarly to Shanghai Huarui Bank, the Tianjin KinCheng Bank was introduced in the newly-founded Tianjin Free-Trade Zone.[47] It has raised capital of 3 billion yuan (US$483.3 million) from 16 private enterprises.[48] The Huabei Group and Tianjin Maigou Group, two largest shareholders of KinCheng, hold 20 per cent and 18 per cent of its stake respectively.[49] The Tianjin KinCheng Bank will offer comprehensive financial services for the local region, with a special focus on corporate banking for SMEs and micro companies. It will not only facilitate the establishment of the latest Tianjin Free-Trade Zone, but will also widely serve clients from the Beijing-Tianjin-Hebei area, the largest economic and urban area in the North China.

The fifth pilot bank coming this year is Mybank. It is set up as an online-only bank similarly to WeBank, and its main shareholder is Alibaba, an E-commerce giant. Mybank received the approval from the CBRC to start operating in June 2015, with registered capital of 4 billion yuan ($645 million).[50] The Ant Financial, the financial unit of the Alibaba group, holds a 30 percent stake in Mybank, and the Fosun International Ltd and Wanxiang Group will hold 25 percent and 18 percent stakes in the new lender, respectively.[51] Yu Shengfa, the head of Mybank, told the Reuters: "Mybank is an important milestone for Ant Financial's development to provide financial services for small and micro enterprises and individuals."[52]

6. CHALLENGES FOR NEW LENDERS

Generally speaking, the first five pilot banks have been running smoothly so far, and a number of new lenders will also start operation in the upcoming year. However, here we will evaluate some potential challenges faced by newcomers in China's banking industry.

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46 "Shades of Grey: Wenzhou's Shadow Banking System Has Taken a Knock" *The Economist* (26 May 2012) online: <www.economist.com/node/21555769>.

47 "KinCheng Bank eyes corporate banking with focus on capital region" *ChinaDaily* (28 April 2015) online: <http://www.chinadaily.com.cn/business/2015-04/28/content_20563097.htm>.

48 *Ibid.*

49 *Ibid.*

50 "Alibaba-affiliated online bank get green light from China regulator" *Reuters* (27 May 2015) online: <http://www.reuters.com/article/us-alibaba-bank-idUSKBN0OC0SI20150527>.

51 *Ibid.*

52 *Ibid.*

First of all, in terms of size, the five new banks are much smaller compared to the dominant state-owned banks. Most of the privately funded lenders have only opened one or two branches, not to mention WeBank and MyBank, which do not have physical branches at all. In contrast, ICBC, the largest lender in China, has an extensive network consisting of more than 17,000 domestic branches and 338 overseas branches or offices in 41 countries.[53] In terms of registered capital, MyBank has 4 billion yuan, each of WeBank, Shanghai Huarui Bank and Tianjin Kincheng Bank has 3 billion yuan, and Wenzhou Minshang Bank only has 2 billion yuan. At present, the capital adequacy requirement in China is 8 per cent, which means that they can only receive limited deposits according to the capital restriction. From this perspective, they could hardly rival with mainstream banks possessing trillions of assets. Due to the fact that they have limited capital and a limited number of branches, if any, the lending abilities of the new banks could be unsustainable.

Second, China's banking sector is now facing the problem of shrinking profit margins due to the increased internal and external competitions. The latest data show that since the beginning of 2015, Chinese banks have witnessed the slowest profit growth rates in 12 years, and the growth could become even weaker in the second half of 2015.[54] As China is carrying out interest rate liberalisation, the competition among existing lenders has greatly intensified. For a long time, the deposit and lending rates in China have been set by the People's Bank of China (PBOC), the central bank, but now it is going to let Chinese banks determine their own pricing of borrowing and lending.[55] The PBOC already removed the restriction of lending rate, and has been trying to abolish the cap on deposit rate as well. In May 2015, when the PBOC cut the benchmark interest rate, it also expanded the deposit-rate ceiling from 130 per cent to 150 per cent of the benchmark.[56] As a result, many Chinese lenders chose to raise deposit rates to solicit depositors, which greatly squeezed their profit margins.[57] Furthermore, Chinese banks are also encountering new competition coming from outside of the banking industry, such as an increasing number of internet-based financial service providers, who offer attractive returns, and as a result have captured billions of yuan from the banks in respect to deposits. For instance, Alibaba's

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[53] "ICBC 2014 Business Overview" *ICBC* online: <http://www.icbc-ltd.com/ICBCLtd/About%20Us/Introduction/>.

[54] Ed Zhang, "Days of high profit growth are over" *China Daily (Europe)* (1 May 2015) at 13.

[55] Chi Lo, "Here's what interest rate liberalisation means for China" *South China Morning Post* (9 November 2015) online: <http://www.scmp.com/business/banking-finance/article/1877144/heres-what-interest-rate-liberalisation-means-china>.

[56] Patti Waldmeir, "China cuts rates for third time in six months" *Financial Times* (10 May 2015).

[57] Gabriel Wildau, "Interest rate deregulation dents China bank profits" *Financial Times* (1 November 2015) online: ft.com <http://www.ft.com/cms/s/0/973c3294-7ed2-11e5-93c6-bba4b4b36134.html>.

Yuebao (or "leftover treasure"), an online investment product based on money market funds, has become a popular alternative to bank deposits in China.[58] The clients of Yuebao not only enjoy the great liquidity as they can withdraw the fund at any time or use it to pay for any purchases on Alibaba's shopping platforms, but also receive an eye-catching annualised return of nearly 5 per cent which is paid on a daily basis. In short, Yuebao is an E-wallet that can make money for you, so it become particularly popular among the young Chinese population who put their money into it immediately after they receive salaries. It has already served 149 million users, and poses a big challenge for traditional lenders. Accordingly, as the competition increases for Chinese banks to maintain their clients, it does not seem as the right time for new banks to be entering the industry.

Third, the business scope of the newly established banks has been considered fairly limited. As we can see, they operate in a very different way than existing lenders do. For example, WeBank and Mybank are online financial platforms that provide banking services for Internet users who would like to invest or borrow small amounts of money. As for Huarui Bank, Minshang Bank and Kincheng Bank, their business operation is confined to certain regions. Minshang Bank is said to serve small business clients in Wenzhou, while Huarui and Kincheng banks mainly offer loans to trade-related SMEs in the Free Trade Zones. Accordingly, it might take a long time for them to develop into large banking groups, in order to compete with the Big Four and other national banks. It is also clear that the priority of these new lenders is to satisfy the financing need of small businesses and personal consumers who have restricted access to the formal banking sector. Therefore, it is evident that the purpose of establishing the privately-funded commercial banks is to fill the niche in China's credit system and to supplement mainstream lenders. From this perspective, these new lenders could hardly rival traditional banks and break their monopoly status in the traditional business areas.

The final concern for private banks is the lack of qualified professionals. Although promoters of the new banks are successful private conglomerates in their respective industries, they do not have any previous experience in running a bank. To make up for this disadvantage, they must currently recruit experienced bankers from state-owned lenders. For example, the Chairman of KinCheng Bank, Mr. Gao Degao, was the former head of the Tianjin Branch of CCB, China's second largest lender, and KinCheng's President, Mr. Wu Xiaoping, used to be a senior banker at the Shanghai division of CITIC Bank, a medium-sized national bank. Similarly, the President of WeBank, Mr. Cao Tong, served as the Vice President for the Export and Import Bank of China, a policy bank. At the moment, as newly founded banks rely heavily on the supply of qualified bankers from established lenders, they need more time to cultivate their own management teams and improve corporate governance.

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[58] Simon Rabinovitch, "Treasure piles up for Alibaba as depositors desert China's banks" *Financial Times* (20 December 2013).

7. THE REGULATORY RESPONSE

Generally speaking, the newly launched private banks will be subject to the same regulatory requirements as any existing banks despite the differences mentioned above.[59] In early 2015, China Banking Regulatory Commission reshaped its institutional structure and established a new department which is responsible for the supervision of private banks, city commercial banks, and city credit cooperatives.[60] Therefore, these privately-owned banks are formally incorporated into the existing banking regulatory framework.

It should be noted that the main regulatory concern is in respect of the innovative online-only banks, including Webank and Mybank. In contrast to traditional lenders, they have a distinguished business model that is based on latest information technologies such as big data and the cloud computing system, which could raise certain regulatory problems. For instance, as Webank and Mybank do not have real branches, opening account and all transactions including borrowing loans, will be done online, so the verification of users' identification remains both a technical and a legal questions. Presently, WeBank is developing a complex facial recognition system to perform the identification verification, which will be incorporated with national citizen identity card query service centre (which is affiliated to China's minister of public security), so that it can accurately identify users online by cross examining the users' online video photo, the photo on their identity cards, and other biological information provided by the query service centre, which is said to have the highest level of security.[61] However, under the current Chinese regulation, customers have to go to a bank branch to complete identity check in person if they would like to borrow a loan, so whether the new identity recognition system can replace the in-person check requirement remains to be seen.

Furthermore, as the competition increases rapidly in the banking industry, potential bank insolvency becomes possible. In fact, Chinese savers do not believe that banks will fail since Chinese banks have been regarded as public agents backed by the government, so there has been an implicit guarantee that the state will bail out any banks in the financial trouble. Indeed, China's banking sector could hardly be more stable as it has been 16 years since the last bank run.[62] However, currently it is moving towards an open and competitive industry, which features the survival of the fittest, so some protective mechanisms are urgently needed for the Chinese banking sector, such as

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59 *Anderlini*, *supra* note 2.

60 "*CBRC Regulatory Structure Reform*" *CBRC* (20 January 2015) online: <http://www.cbrc.gov.cn/chinese/home/docView/67163D0D8293499BA499-D2A9705C61CD.html>.

61 "Tencent's facial recognition technology development will be applied in Webank for opening bank account" *Xinhua* (15 April 2015).

62 "Deposit Insurance in China: A Premium for Risk" *The Economist* (December 2014) at 82.

deposit insurance which prevents systemic risk and protects bank depositors when bank failures happen. In fact, since 1993 China has been debating whether to introduce deposit insurance, but it has never been such an urgent issue as bank failures have rarely happened in the past.

Consequently, in May 2015, the Chinese government formally established the deposit insurance scheme to cover all deposit-taking institutions in China, whether state-owned lenders or privately funded new banks. There is no doubt that the latest deposit insurance can improve the market discipline to some extent, as more people will be willing to put their money in smaller banks which can offer better rates, as long as their savings are protected by the state. In terms of the coverage, the new scheme will insure deposits of up to 500,000 yuan (US$80,550) per saver per bank. It is said to cover around 98 per cent of all deposit accounts in China's commercial banks, and the level of protection will be adjusted according to the economic development.[63] Moreover, the latest scheme is funded on an *ex ante* basis, namely, all deposit-taking institutions shall pay premiums to the insurer before the potential crisis happens, every 6 months, and the premium will be calculated on a risk-based standard.

8. CONCLUSION

The year of 2015 was a special time for China's financial sector, as we have witnessed many important things happen, including the recent stock market crash and the internationalisation of the Renminbi (the Chinese yuan). However, the establishment of privately funded banks shall not be ignored, which might have significant impact on its state-owned banking sector. On the one hand, the new private banks will collectively provide more credit to China's money-strapped entrepreneurs, which could be good news for the slowing economy. On the other hand, they will bring more competition to the sluggish banking industry, and might break the monopoly of the mighty state-run lenders in the long term.

Nonetheless, we should realize that the latest privately owned banks will not pose a great danger to their state-owned counterparts in the near future. Currently, their primary function is to fill the gap in the existing banking system, as they mainly provide services for small business which are underserved by traditional lenders. Therefore, the new private banks will not be direct challengers to established lenders as they target different groups of clients. Moreover, the newly established private banks also face some potential challenges. First of all, they have relatively few capital and limited geographical presence, which raises the difficulty of sustainable development. Besides, the banking sector in China is facing growing competition from the rise of online financial service providers which provide convenient services and attractive returns for the younger generation. Even within the banking sector

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[63] Gabriel Wildau, "China to Launch Insurance for Bank Deposits" *Financial Times* (29 November 2014) at 4.

itself, the competition has intensified as a result of interest rate liberalisation, so smaller banks will probably raise deposit rates to lure more savers, which will squeeze profit margins. In addition, the new private banks do not yet have enough experienced bankers, and must attract talent from existing lenders.

The fast changing banking arena in China calls for a more efficient and effective regulatory system. Particularly, attention should be paid to the pioneering online-only banks, as the application of new technologies could increase the difficulty of financial regulation. Moreover, the introduction of deposit insurance scheme is great leap forward for China's banking industry, since it will encourage Chinese savers to try new lenders that could offer better services and higher returns.