Journal of
Current Chinese Affairs

China aktuell

Orhan H. Yazar (2015)
Regulation with Chinese Characteristics: Deciphering Banking Regulation in China, in: *Journal of Current Chinese Affairs*, 44, 2, 135–166.

URN: http://nbn-resolving.org/urn/resolver.pl?urn:nbn:de:gbv:18-4-8511

ISSN: 1868-4874 (online), ISSN: 1868-1026 (print)

The online version of this article and the other articles can be found at:
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Published by
GIGA German Institute of Global and Area Studies, Institute of Asian Studies and Hamburg University Press.

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■■■ Journal of Current Chinese Affairs 2/2015: 135–166 G|GA ■■■

Regulation with Chinese Characteristics: Deciphering Banking Regulation in China

Orhan H. YAZAR

Abstract: The regulatory agency responsible for prudential supervision of the banks in China, the China Banking Regulatory Commission (CBRC), is not an independent authority. The agency's regulatory actions are constrained by the central government, which has to balance the prudential and non-prudential consequences of bank regulation for its political survival. The conditions and limits of the government's influence on the CBRC is analysed through an investigation of three regulatory cases. The conclusion is that the CBRC's regulatory actions are determined by the relative importance of prudential outcomes for the government's policy objectives.

■ Manuscript received 27 August 2013; accepted 29 January 2015

Keywords: China, banking, regulation, finance, regulatory state, CCP, CBRC

Dr. Orhan Hilmi Yazar is an assistant professor of International Political Economy at the Global Institute of Management and Economics of the Dongbei University of Finance and Economics in Dalian. His research interests include the politics of regulation, institutional change, national innovation systems and technology policies.
E-mail: <orhanyazar@dufe.edu.cn>

Introduction

China has continued its relatively high pace of economic growth despite the global financial crisis (GFC) and its aftershocks. In 2014 the economy grew by 7.4 per cent, and in 2015 it is expected to grow by approximately 7 per cent. In governance, the new Xi–Li leadership has made headlines all around the world with its campaign against corruption. However, recent financial reforms, which received much less attention, are no less significant. Removing the floor on lending rates, approving the establishment of truly private banks and facilitating greater openness in capital account in the Shanghai Free Trade Zone are policy initiatives moving in the right direction for a more efficient financial system. Despite these positive steps and improvements in the regulatory framework, highly leveraged local governments, a slowing property market and the expansion of shadow banking pose a threat to the overall stability of the financial system, particularly the banking system. Growing interdependency between the world markets and China has drawn a lot of attention from scholars to the health and stability of China's banking sector, which provides most of the funding for the country's growth. However, this attention is skewed toward non-performing loans (NPLs), ownership structure, liberalization and, more recently, shadow banking. This paper[1] focuses on another key aspect of China's banking sector, as it investigates the capacity of the Chinese state to regulate and supervise the banking industry.

The Chinese state, governing a vast land with great diversity in terms of economic development, has to respond to conflicting policy objectives. The one-party political system in China and the entailing desire of the Chinese Communist Party (CCP) to continue its rule with an "output-oriented" legitimacy (Scharpf 1999) requires its main governing body – the central government – to deliver positive policy outcomes that will be acceptable to society. The central government,

1 I would like to express my gratitude to the Global Institute of Management and Economics of the Dongbei University of Finance and Economics for their research support. I also wish to thank Dr. James Reilly from the University of Sydney, Prof. Tariq Malik from the Dongbei University of Finance and Economics and Prof. Yu-Kyung Kim from the Sogang University for their comments and advice on the initial drafts of this paper. Last, I would like to thank the anonymous reviewers from the *Journal of Current Chinese Affairs* for their constructive comments and helpful suggestions. Any errors are mine.

which is mandated to preserve social stability along with ensuring rapid economic growth, obliges the state apparatus under its control to answer to demands, contradictory at times, from society and the market simultaneously. The bureaucratic organizations – which are highly dependent on the CCP and the central government to exercise authority – are affected, as the central government struggles to handle contradicting policy objectives. The lack of independence of the bureaucratic organizations pushes them to follow biased central government policies that aim to induce higher growth, improve equity in society or reach other desirable policy objectives. Banking-sector regulation and supervision is one area exhibiting a potential for clashes between the overall party objectives and narrow bureaucratic tasks.

The Chinese Banking Regulatory Commission (CBRC) is the "independent" bureaucratic organization responsible for bank regulation and supervision in China and also a unit accountable to the Chinese government. For the CBRC, at times, the bureaucratic mission and directives developed by party leadership have conflicting objectives. These conflicts and the absolute authority of the government over the CBRC are expected to give rise to regulatory forbearance and weak oversight.

Despite this expectation, in recent years the CBRC has demonstrated increasing capacity to regulate the banking system in some areas while succumbing to the central government's demands in others. In order to explain the variations in regulatory performance, I analyse regulatory governance in China and the regulator's capacity to act independently in various cases. I observe the behaviour of the CBRC in three regulatory events that took place between 2008 and 2013. I present the backgrounds, actors involved and chains of events that led to the regulatory outcomes – stringent or lax regulation – in each case. The cases presented are built on the statements in the local media made by the actors involved, public announcements and reports published by public or private agents.

In the next section, I discuss the use of regulation as a governance tool in China and the relationship between the government and the regulatory authority. In the section following that, I briefly present the development of the banking sector and bank regulation in China. Then, in a subsequent section, I introduce the dilemmas faced by the CBRC and use three cases to illustrate how the regulator dealt

with each of these dilemmas. Last, I discuss my findings and present my conclusion.

Understanding Bank Regulation in the Chinese Context

China frequently uses regulatory tools to steer its economy, and China's actions in this regard may resemble those of any other regulatory state. The distinctiveness of Chinese regulation, and bank regulation in particular, stems from the different motivations behind its regulatory actions. In the advanced capitalist economies, regulation as a way of intervening in the economy to correct possible market failures by the state has been an important policy tool. We can cite four main drivers of the adoption of bank regulation: to prevent regulatory capture, to provide a public good by a benevolent regulator, to converge with international rules and to use bank regulation as an economic governance tool. These motives are supported by various explanations for bank regulation in the literature.

The regulatory capture explanation points out the inevitability of the capture of a state's regulatory function by those being regulated. The banks, as a powerful and organized interest group with extensive resources, will lobby the regulators and legislators for regulatory forbearance and laxity. Without counter-initiatives from the public, the regulatory environment will favour the banks' interests and the regulatory function of the state will be dictated by the banks (see Stigler 1971; Peltzman 1989; Shleifer and Vishny 1998; Shleifer 2005).

In contrast, the benevolent regulator explanation expresses the existence of market externalities and the possibility of market failures that may endanger the soundness of the financial system and erode the savings of the public (see Pigou 1938; Keeley and Furlong 1986; Barth, Caprio, and Levine 2006). In the face of such threats, the state will act to protect the public interest by rigorously supervising the banks and preventing excessive risk-taking. According to this view, the state's regulatory function will uphold the public interest and reflect the preferences of the benevolent regulators working on the public's behalf.

The international rule convergence explanation draws our attention to the development of international prudential standards and regulatory rules. While financial globalization has increased cross-

border activities of financial institutions and the volume of financial transactions, it has also created pressure for states to provide regulatory environments no less favourable than those offered in other places, in order to keep national financial institutions at home and attract international investors. To avert the risks of regulatory arbitrage and a race to the bottom in financial regulations, major states with large financial services industries have worked together on several occasions to reach a set of common prudential standards. The Basel Accords were the result of such cooperation. Those standards, agreed upon by several states, proliferated over time across the globe and have become international rules with the encouragement of international organizations and the willingness of some states to signal to international investors the quality of their regulatory environment. Hence, the international rule convergence explanation says that a state performs its regulatory function according to international cooperation and agreements (see Gadinis 2008; Acharya 2003).

Last, the regulatory state explanation sees the bank-regulation function of the state as being closely related to the existing state–business relationship and views the role of regulation as a tool for steering the economy. The regulatory state deliberately moves the regulation of banks away from being relational, informal and open to capture and delegates its regulatory function to an independent regulatory agency (see Moran 2001; Thatcher 2002; Gilardi 2008).

Chinese political economy is significantly different from that of the countries where these explanations were born and where they exerted influence on the regulatory functions of the state. Hence, though they may shed some light onto the Chinese experience of bank regulation, they are inadequate to capture the divergence from the regulatory models of the capitalist economies. This paper attempts to show the distinct features of China's bank regulation despite the steps taken in the early 2000s to converge with the independent regulatory authority model.

Dependent Delegated Regulation in China

China's regulatory framework has significantly changed since the turn of the millennium. Faced with large sums of non-performing loans in the late 1990s, the Chinese government decided to reform the bank regulation and supervision system and adopt an independent-regula-

tor model, which was the internationally accepted best practice at the time. This model introduced an "independent" authority to monitor risks and take action should the stability of the financial system be endangered by the banks. The arguments for having such an authority, despite increasing costs for the state, are similar to those in favour of central bank independence. Unlike ministries, an independent bureaucratic agency is less likely to adopt regulatory policies that will favour banks in return for political support. Furthermore, a specialized agency can supervise more effectively than could a ministry, which has multiple tasks and mandates.

Such delegation of decision-making power to bureaucratic organizations in a principal–agent framework was common in China, where the party was aware of the complexities of governance and chose to use expert bureaucrats to increase governance efficiency. However, unlike governing parties in other countries, the CCP followed the activities of bureaucratic organizations very closely and steered them towards consensus, preventing an abrupt shift from party policies (Shirk 1992).

The vastness of China's geography also made the delegation of authority from central to local levels in a principal–agent framework an imperative for governance efficiency. In China, economic and political decisions made by the central government are administered by the local governments at provincial levels. The government, as the principal, delegates its governing function to local governments, which act as agents. However, the consequences of such delegation may not always result in good governance, especially when local governments and firms collude to produce outcomes that diminish public goods, such as local protectionism (Young 2000) or lax work-safety standards (Jia and Nie 2012).

The new independent-regulator model added an additional layer of bureaucracy to China's governance and formed a three-layered governance structure comprised of the principal, supervisor and agent (P-S-A). In this P-S-A model, the principal delegates its authority to the supervisor to inspect the agents and ensure their compliance or good performance (Tirole 1986). Adding a third party between the principal and the agent is expected to increase efficiency in monitoring and evaluation. Yet, informational asymmetries between the principal and the supervisor may result in collusive behaviour between the supervisor and agent, in order to mislead the principal about the

agent's performance (Faure-Grimaud, Laffont, and Martimort 2002). The re-emergence of political actors in the financial regulatory frameworks in the US and other countries (Gadinis 2012) can be regarded as a reaction to such collusion between the supervisor and the agents in the years preceding the 2008 GFC.

This three-tiered agency model takes into consideration the possibility of collusion between the supervisor and the agent but fails to consider the possibility of collusion between the principal and the agent, especially when the principal has more than a single objective or actively seeks outcomes other than the supervisor's mandate. In bank regulation, the central government (principal) may delegate its power to an independent agency (supervisor) to monitor risks at the banks (agents); however, low risk-taking in the banking sector may not be the only output that the government (principal) demands from the banks (agents). Hence, conflicts between the central government's objectives and the supervisor's mandate can result in collusion between the principal and the agents, forcing the supervisor to use "selective supervision" (Motta 2010) and regulatory forbearance.

This paper argues that applying the principal-agent-supervisor framework in China will produce only partially efficiency-enhancing results due to China's institutional differences from other countries in which the P-S-A framework is applied. In China, state ownership continues to dominate the banking sector. The central government, which can control the operations of banks through patronage and the party-state hierarchy, relies on the banking sector for its developmental objectives and also has control over the bank regulators. Hence, in addition to the risk of collusion between the supervisor and agents, in the Chinese context the risk of collusion between the principal and the agents threatens effective prudential supervision.

The central government, as the principal, can weaken the bank regulator's mandate and engage directly with the agents in order to obtain regulatory outcomes supportive of its political survival. The bank-regulation process produces not only regulatory prudence or less risk-taking, but also varying economic outcomes dependent on the amount and direction of bank credit. As the principal, the central government may collude with banks or other actors involved in the financial-intermediation process in order to manage non-prudential outcomes that may be more valuable as political assets. To under-

stand the conditions that may lead to such collusion, we first need to understand the limits of regulatory space in China's governance.

The Chinese Regulatory State

The notion of a party-state with absolute control over both input and output of policy may be a popular way of viewing Chinese governance for those outside China. However, discrepancies between policy formulation and policy implementation have been a recurring theme in the Chinese political economy and tell a different story. As initially suggested by Lieberthal, who used the term "fragmented authoritarianism" in this regard, the party's executive power has been contested several times by other agencies and related parties that have sought incremental changes to initial policy designs or targets (Lieberthal and Oksenberg 1988; Mertha 2009). The policy makers at the top are aware of the loss during the policy transmission and usually collude with the receiving end of the policies to continue their rule (O'Brien 2009).

In China, the policy transmission process has become more intriguing in the last ten years with the introduction of several government agencies to regulate economic activities in areas like banking, securities, the environment and food safety. The emerging regulatory state in China resembles the Western model in many respects; however, it still evinces features of a developmental state (Pearson 2005; Bach, Newman, and Weber 2006). It is important to highlight the distinctiveness of regulation with Chinese characteristics.

Following regulation is a difficult task in China due to the opaqueness of the state apparatus. Actors and organizations involved in regulatory governance of specific policy areas rarely reveal their true nature. Despite this, scholars are still attempting to get a glimpse of the regulatory state in China. The contradiction between the CCP's tight oversight of regulatory agencies and their need to act independently is commonly recognized (see Mushkat and Mushkat 2012). New regulatory agencies that have flourished in the last ten years in China serve to ensure the party's role in economic governance rather than to open a space for independent technocratic actors. The diversion of Chinese regulatory governance from international norms, despite increasing links between the Chinese regulatory agencies and their counterparts, keeps the possibility of regulatory convergence at

bay. The significance and strategic value of various sectors define the stringency of regulatory controls in each sector (Hsueh 2012). Yet, Chinese political and market structures make the development of several regulatory trajectories possible (Pearson 2005, 2007). The independent regulatory agency model, in which the government delegates its authority to decrease regulatory capture, rent-seeking and collusion risks as it guides the market, has been adapted to the Chinese political economy.

The delegation of the regulatory and supervisory powers to a separate organization within the state results in decentralization and increases efficiency, but does not end collusion. The regulatory authority receives a conditional delegation in which the objectives of the party have the highest priority. Hence, China continues to present features of an interventionist developmental state despite having adopted an independent agency model. Regulatory agencies and regulation of banks follow a regulatory path that is consistent with the extant institutional context rather than following the global model. The idea of a regulator free from political interference and cut off from incentives that may affect their operational integrity in the global model resonates weakly with Chinese regulators.

In China, regulators' obligations generated by relationships and the incentives to nurture these relationships are as important as, if not more important than, bureaucratic obligations. In a political system dominated by one party, Chinese regulators cannot easily ignore political institutions and their demands. Among these institutions, the central government's preferences take priority, as they reflect the preferences of the top decision makers who have almost absolute authority to promote and demote bureaucratic staff. If the central government's preferences are key to understanding bureaucratic behaviour in China, it is necessary to look at its regulatory preferences in bank regulation cases.

In discussing the stagnation of financial reform in China, Shih suggests that control over financial resources empowers political leaders and helps them to build up a strong network of supporters, decreasing the possibility of efficiency-enhancing reform (Shih 2006). Following Shih's insight, it can be suggested that the regulatory preferences of the party leaders will depend on the rent-distributing consequences of regulatory outcomes and the consequences of regulatory failure for the continuity of the party elite's rule. The CBRC as a "de-

pendent" regulatory agency cannot ignore these preferences. When the central government, as the principal, sees fit to loosen or strengthen control over the agents for politically favourable outcomes other than a prudent banking system, the CBRC, as the supervisor, has little opportunity to act otherwise.

Hence, in China's banking regulation, we observe a dependent regulatory state model that is constrained by the party's political objectives and the individual duties of the actors involved to honour expectations generated by relationships. The regulation takes place in a permitted space in which great pains are taken not to damage any ties between the regulators and other actors.

The Banking Sector in China

The banking sector in China makes up over 70 per cent of the country's financial market. Its huge dominance can be explained by the state's total ownership of all capital, including bank capital, prior to the market reforms of 1978 and the very tentative steps of the government to liberalize the financial system in ensuing years. Before 1978, there was only a single bank in China, the People's Bank of China (PBOC), which played the dual roles of a commercial and a central bank. After the market reforms in 1978, this singular structure was divided into several government banks with various tasks in different economic areas. The so-called "big four" – the Bank of China (BOC), Agricultural Bank of China (ABC), China Construction Bank (CCB) and Industrial and Commercial Bank of China (ICBC) – were established and until 1985 were restricted to acting within their respective state-defined areas. From 1985 onward, more competition was introduced to the banking system and small and medium-sized commercial banks were established by either city governments or joint ventures. In the 1990s, Chinese banks accumulated huge numbers of NPLs – mainly due to their continuous support for loss-making state-owned enterprises. The government was forced to take over the NPLs from banks and transfer them to the so-called "asset management companies" (AMCs) in 1999. Finally, China's accession to the World Trade Organization (WTO) has opened the banking sector to limited foreign participation.

Since the turn of the millennium, the Chinese banking system has improved significantly, especially with competitive and interna-

tional regulatory pressure brought by the WTO. In 2003 a new, more assertive regulatory authority, the CBRC, was established. With the CBRC, the bank supervisory functions were separated from the PBOC; however, the PBOC continues to be responsible for the overall stability of the financial system (Bell and Feng 2013). International standards such as those created under the Basel Accords have become more influential in regulation, although with limited and selective implementation (Cousin 2011). The "big four" state banks were allowed to have foreign partners and were listed in the stock market. Corporate governance of banks has also received more attention recently.

Despite these developments, the political constraints on banks and their role in the economy as expansionary or deflationary tools continued to hinder their rapid reform. Independent bank boards or regulators were still out of the question. As Carney points out in his evaluation of China's banking reforms after 2002:

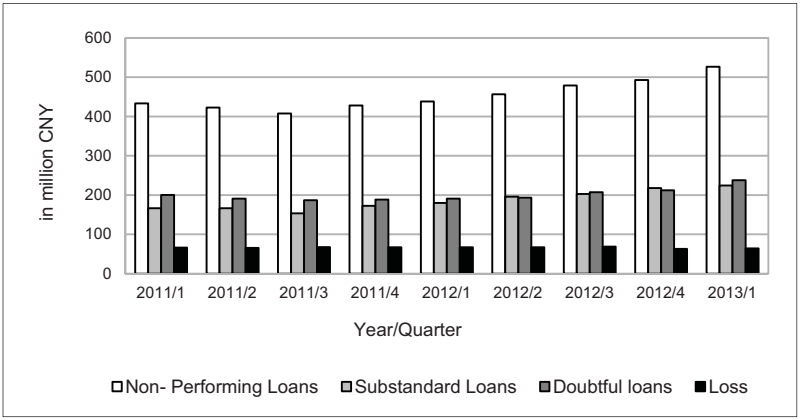
> Although regulatory reforms of major banks were guided by international standards, their implementation exhibited numerous departures from the intention of the rules. For example, those standards that tended concentrate key powers in the centre of banking and supervisory hierarchies were implemented rather vigorously, while principles that required independence of banks' boards and regulators were ignored in order to retain CCP control (Carney 2012: 22).

In the latest episode of loose monetary policy in 2008, the Chinese government's huge stimulus package was channelled through the banking system with less stringent risk management. The funds provided by the banking industry to the property developers and SOEs are at a significant risk of becoming NPLs, as Figure 1 illustrates.

The uncertainties and stricter controls in the property market are likely to increase the risk of default for the banks (Deloitte China Financial Services Industry Center of Excellence 2012). The decreasing profits of SOEs, especially the local government-controlled SOEs, which saw an almost 15 per cent decline in profits in the first four months of 2013 (MoF 2013), cast doubts on their ability to repay their loans. Considering China has not been able to get rid of its existing NPL portfolio in the AMCs, some see a great threat to the stability of the banking sector in China in the coming years (Pettis 2012). Others suggest that China's huge foreign-currency reserves

and low debt-to-GDP ratio will allow the Chinese government to intervene to prevent any instability in the banking sector. Besides old problems, the Chinese banking system faces risks from alternative financing mechanisms such as internet financing, shadow banking, new financial products and relatively weak economic growth. In this context, it is important to understand China's bank regulation and the role of the regulator in managing risks in the Chinese banking industry.

Figure 1: Non-Performing Loans



Source: Author's own compilation.

The CBRC

The CBRC was established in 2003 after a series of banking scandals hit the news and both foreign and local observers pointed out the lack of regulatory capacity in China's banking system, which was preparing to open its doors to foreign banks. At the beginning of the 2000s, Chinese officials were displeased with several events that shook society's confidence in the banking system and its official management. One incident, an elaborate scheme which allowed two bank managers in Kaiping, Guandong, to embezzle 485 million USD over ten years, was discovered in 2001 (*China Daily* 2008). In a separate incident in 2002, US authorities discovered that the head of Bank of China was involved in a connected-lending scandal at the New York branch (Peng 2007).

However, the development of necessary capacity to regulate foreign banks, which were expected to operate in China with the WTO agreement, gave government a strong incentive to strengthen bank regulation. Entry of the global banking giants into the country and the possibility of future takeovers (see Nolan 2008) gave further incentive to the Chinese government to strengthen banks and discipline their management.

In the face of banking scandals and future challenges, the regulatory function of the People's Bank of China was called into question. In early 2002, the Central Financial Work Commission started working on a re-organization plan for bank regulation ahead of the 10th National People's Congress (Naughton 2003). The new bank regulator's establishment was swift and the legal tools required by the regulator were provided quickly after its establishment. It has developed a large network of regulatory offices spread over 36 cities in China. It is well staffed, and 77.4 per cent of the employees have university degrees or other higher-level educational credentials (CBRC 2012).

Although the CBRC was given operational independence in the banking law, the State Council's authoritative control casts doubts on the limits of the CBRC's independence. Moreover, there is overlap between the mandates of the PBOC and the CBRC in some areas such as regulation of micro-finance and interbank lending (Gong and Zhou 2012). As China's banking system becomes saturated and begins to experiment with new financial instruments, the CBRC's job is becoming more complicated than simply enforcing capital adequacy ratios at banks (Chang, Ting, and Ma 2012).

The Dilemma of the CBRC

The CBRC as an organization was established to regulate and supervise the banking sector in China. This function entails a responsibility to encourage better risk-management practices in the banking industry and appropriately punish those who fail to act accordingly. Hence, the CBRC's primary mission is to mitigate excessive risk-taking behaviour in the banking system, which is the main pillar of the financial system in China.

But the CBRC is a state agency that is not independent from the CCP and its leadership. As a part of the Chinese state system, the CBRC has to follow guidelines provided by the State Council or the

Chinese government. These guidelines may be in regards to macro-economic policy, rural development or specific issues like curbing real estate prices. The main objectives of the Chinese government when choosing macro-economic policy are guided by growth considerations and a desire to maintain China's social stability. To achieve these objectives, the Chinese government will leave market rules and mechanisms aside from time to time. This tendency can reveal itself in the efforts of the Chinese government to control prices of poultry and other food items to tame inflation or to use exorbitant taxation to prevent speculative sales in the housing market. The elasticity of market rules and mechanisms also manifests itself in decisions to ease or halt credit pouring into the financial system through banks. During the inflationary phases of economic cycles, the government can order a minimal release of funds to the market, and in periods of contraction it can flush the market with money, as happened following the 2008 GFC.

The CBRC, fighting excessive risk-taking in the banking system, faces a dilemma when the central government issues directives to increase investment in the entire economy or specific areas of it mostly funded by bank credit. The encouragement of more risk-taking by the government clashes with the essential risk-control duty of the CBRC. The CBRC cannot ignore the central government but also cannot fail in its risk control duties. Moreover, the incentive structure for career development exacerbates the CBRC bureaucrats' dilemma.

In the Chinese bureaucratic system, promotions usually rely on strong networks and the performance records of the bureaucrats. On one hand, the CBRC bureaucrats try to avoid any failure in the area of risk control that may result in a banking crisis and, consequently, poor performance records. On the other hand, as it is common for financial cadres of the CCP to be promoted from executive positions at banks to regulatory institutions and vice versa (Martin 2012), these cadres will try not to alienate their political patrons by disregarding their demands, which may strain their relationships and future career prospects. Hence, the CBRC bureaucrats have to manage their political and bureaucratic obligations simultaneously and cautiously.

At either the central or the local level, the government, which may apply pressure to the CBRC to ensure politically favourable outcomes, has to take measured steps in their control as well. A banking crisis that may destabilize economic growth and cause social instabil-

ity would be a political disaster for the CCP. Closing businesses, laid-off workers, bankrupt businesspeople and masses who cannot access their hard-earned savings – this is not a favourable scenario for the party. The government, despite its ability to control the CBRC absolutely, thus controls only loosely, as bank regulation and supervision is of key importance for political and social stability. The three cases presented below will illustrate how the CBRC performs its duties in various circumstances when faced with contradicting demands from the "principal".

Regulating China's Banks

As the Chinese financial system is dominated by bank financing, the CBRC is a part of the discussion in regards to major economic decisions and events in the country. The financial diversification demands of the rising middle class, the financing difficulties of small and medium-sized enterprises (SMEs), the management of local-government debt, shifts in the country's economic model and other key economic issues require policy contribution from the CBRC. The CBRC has to carefully thread its way through policy discussions and take actions to fulfil its regulatory functions without clashing with the government's policy guidelines. In late 2011, handling the crisis-like situation in Wenzhou, the CBRC demonstrated this balanced regulation strategy.

The Wenzhou Mini-Crisis

Wenzhou, a city located in the southeast of China in Zhejiang Province, is home to small and medium-sized enterprises exporting labour-intensive light industry products. Wenzhou has been a model for other Chinese cities for its rapid export-led economic development, entrepreneurship and use of informal finance (Tsai 2006). As many export businesses need flexibility in business operations, Wenzhou businesses have to keep their company funds liquid. Hence, besides conventional bank loans, businesses in Wenzhou rely heavily on informal finance provided by wealthy individuals. Large sums of money can change hands each day, even without any written records of the debt. The city's strong economy ensures that debts are paid on time.

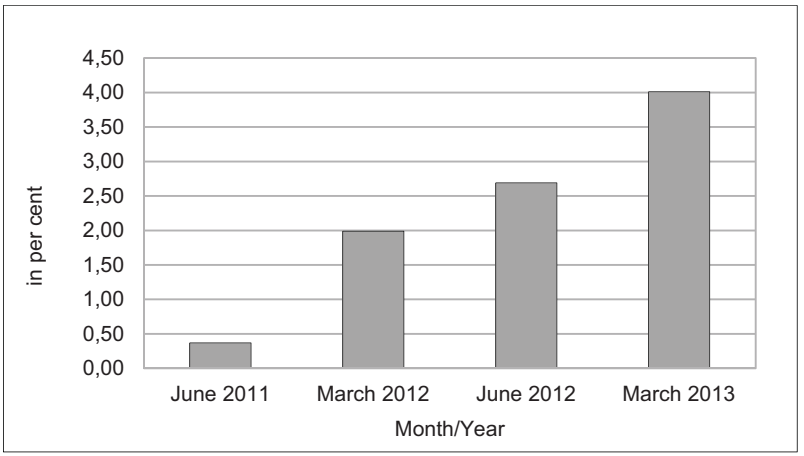
However, after the GFC, Wenzhou businesses suffered due to orders from their usual export customers in the US and Europe being cancelled. Banks facing higher reserve-ratio requirements from the central bank after 2010 further tightened the credit supply to SMEs, including to businesses in Wenzhou. As Zhang Lijun from China Everbright Bank explained, it was "definitely winter" for the SMEs, as banks chose to lend to "big, state-owned enterprises" (Jia 2011). The weak sales and financial hardships of some Wenzhou companies led to unpaid debts both at the informal and formal financial platforms. The situation took a dramatic turn when one of the prominent business owners from Wenzhou escaped to the US to protect himself from angry financiers (Lan 2011). This incident was followed by others, revealing a widespread debt problem in Wenzhou.

The possibility of a widespread economic and financial collapse in Wenzhou pushed the central government to act. The Chinese premier at the time, Wen Jiabao, in a Deng Xiaoping-style southern tour, visited Wenzhou and expressed the government's support for the SMEs. During his visit, Wen suggested that banks "should increase their tolerance for non-performing loan ratios of small enterprises" (Wang 2011). As one employee of a state bank in Wenzhou expressed, the CBRC repeatedly called for a more tolerant approach to SMEs and greater acceptance of NPLs (Wang 2012). It has also advised its own branches to apply a different risk-assessment standard to credits for small businesses and increase their tolerance of NPLs for these companies (CBRC 2011b). As a result of this lenient approach, by the end of June 2012 Wenzhou's rate of NPLs reached 2.69 per cent, a ten-year high, up from 0.37 per cent in 2011. In the first quarter of 2013, this rate further increased to 4.01 per cent (see Figure 2).

In the case of Wenzhou, the CBRC clearly followed the central government's directive instead of its mandate to prevent excessive risk-taking. The central government's regulatory preferences tilted towards lax regulation in order to prevent a financial and social crisis that could undermine the party's rule and bring its leaders' ability to govern into question. In order to avoid such an outcome, intervention at the highest level, illustrating the central government's high interest in the case, allowed SMEs to capture the regulatory process. The central government, as the principal, asked for leniency on behalf of the debtors. The CBRC, as the supervisor, had to give in when the

central government decided that protecting SMEs was more important for the CCP than was regulatory prudence. The conflicting objectives of the principal made collusion between the principal and banks possible and resulted in regulatory forbearance.

Figure 2: Wenzhou Non-Performing Loan Ratio



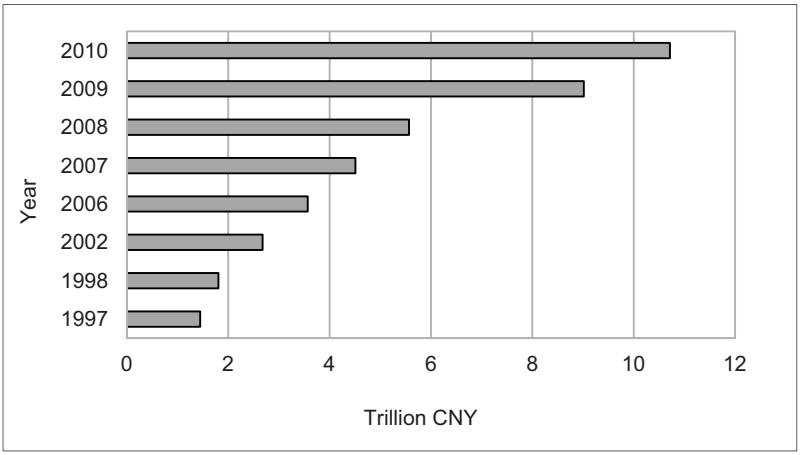
Source: Author's own compilation.

Local Government Financing Platforms

The relationship between the local governments and the central government has always been quite important for the economic governance of China. A crucial aspect of that relationship has been the arrangements to share fiscal revenues and responsibilities. Changes in the principles guiding the fiscal responsibilities and the revenue-sharing scheme have had serious consequences for the incomes and expenditures of local governments. The latest of those changes occurred with the 1994 tax reforms, which decreased local-government revenues and increased their fiscal responsibility to provide public services (Zheng 2009). Faced with a growing gap between revenues and expenditures, local governments had to find innovative ways of financing, as they were not allowed to borrow from the capital markets – in other words, from the banks directly. To circumvent this ban, local governments used state-owned enterprises (Jin and Zou 2002) and established government-backed financing companies to

borrow from the local banks. The latter, so-called local government financing platforms (LGFP), are less transparent in their risk assessments and accounting and rely heavily on land sales for their revenue stream (Rutkowski 2013). As Figure 3 illustrates, this opaque form of local-government borrowing has increased immensely since the 500 billion USD stimulus spending, reaching 2.53 trillion USD, making up 29 per cent of the country's GDP (Chao 2013). As Lu and Sun suggest, "most of the funding needs were met through LGFPs' borrowing from commercial banks, *with the guidance to do so by the PBC and CBRC*" (Li and Sun 2013; emphasis added).

Figure 3: Local Government Debt 1997–2010



Source: National Audit Report 2011: 3.

Since the problem was first recognized, in 2009, different stakeholders affected by the high debt level of local governments have acted according to their own particular interests. The CBRC was aware of the risk of default and tried to mitigate the risk in banks by issuing decrees and publicly warning banks. The policy makers in the central government, although acknowledging the problem, did not want to take decisive action. They believed that since many of the projects, such as toll roads, could generate income in the long run and need continuing financial resources to be completed, strict controls on new lending to LGFPs would be counterproductive. Banks, on the other

hand, were reluctant to stop lending to LGFPs, as they were competing for growth and as local governments were their preferred customers. Moreover, the relationship between local bank branches and local governments made it difficult for loan officers to deny loan requests from the LGFPs, especially in the case of city commercial banks. Hence, the exposure of city commercial banks to LGFPs is higher than the exposure of other banks to LGFPs (Wang and Zhang 2010). Local governments tried to avoid any limitations on new borrowing by using technicalities in the published guidelines and used new financial tools, such as corporate bonds, to make up for the regulatory crunch.

The leadership change that took place at the end of 2012 and the volatility caused by the world economic recovery have affected the capacity of the CBRC to implement measures necessary to decisively tackle the local government debt problem. In the Chinese political system, a leadership change at the top consequently entails staff changes at all government levels, government agencies and SOEs. Almost all of the stakeholders in the LGFP debt problem were affected by this change, including the CBRC, the CEOs of the "big four" banks, local government officials and central government leadership. The local government officials who were soon to leave their posts did not have much incentive to decrease their borrowing while the newly appointed local government officials announced ambitious spending plans to spur growth. With no incentives to cut spending, local government debt increased by 70 per cent from the end of 2010 to June 2013, according to the latest National Audit Office (NOA) report on local government debt (Mitchell 2013).

The soar in the local government debt in less than three years indicates the inability of regulatory authorities to control the risk-taking of banks and local governments. Despite the CBRC's incentive to act as the "benevolent supervisor" in the regulatory system, the "agents" were able to expand credit with high risks. This would not have been possible without the intervention of the "principal", which had an incentive to avoid any sharp decreases in growth, hence it showed leniency towards the banks. The slow and unstable recovery of the world economy has contributed to the relatively slow growth in China, and falling inflation made the principal – the central government – prioritize growth over other concerns. The impact of monetary loosening by means of non-traditional monetary policy

tools such as bank reserve-requirement ratios and lending targets for the banks removed some of the urgency of solving the debt problem for local governments and banks. The new CBRC leadership appointed at the end of 2011 initially approached the problem with a heavy hand; however, it later had to accommodate the demands of the central government, which was not in favour of cutting the available credit to the local governments at once (Li 2013). As an official from the CBRC said to a reporter in mid-2012, "this was a natural decision for the CBRC, as stabilizing economic growth has become government's top priority" (*China Daily* 2012). The CBRC had to accommodate the principal's objectives, such as encouraging banks to lend to local governments for affordable housing projects (see CBRC 2011a) while trying to mitigate risks at LGFPs.

The currently slowing Chinese economy and the central government's efforts to control rising property prices have clearly decreased the capacity of the local governments, which rely heavily on land sales for revenues, to service their debt. Hence, the possibility of default by the LGFPs is posing a real threat to the stability of the banking system. The local governments are counting on the central government to bail them out. Although the central government has not clearly addressed how it intends to approach local government debt, it signalled that it will be ready to provide support by allowing local AMCs to be established, which can help to diffuse the issue, just like China did 15 years ago with the big state banks. We have already witnessed the establishment of local AMCs to buy bad debt from the local governments in the leading economic centres of the country like Shanghai, Guangdong, Jiangsu, Zhejiang and Anhui with approval from the CBRC (Collier 2014). Their numbers increased very recently with new AMCs in Beijing, Tianjin, Chongqing, Fujian and Liaoning (Li 2014), and other local governments are in line to set up such companies to off-load bank NPLs and bad assets.

Moreover, the latest audit report from the NOA suggests that a huge part of the debt that was supposed to mature by the end 2013 was refinanced (Rabinovitch 2014), indicating rollover of existing debt obligations rather than pushing for a "harder" budget. Still, the responsibility to avoid a large-scale default lies with the CBRC, which has tried since mid-2009 to take appropriate steps to prevent the problem getting even bigger. However, either the steps taken by the CBRC were circumvented by the banks and LGFPs in some manner

or the central government's growth concerns guided the CBRC's actions.

In the case of local government debt, the central government again preferred lax regulation. First, the central government did not want to further weaken local economies. Second, strict controls in new loans would decrease capacity to service existing debt for outgoing local party bosses and constrain new local party leaders from starting new investments. The retiring party leaders seeking post-transition influence could not risk alienating incumbent local party leaders, while the new leaders could not afford to lose the support of the new local cadres. Hence, by its inaction, the central government set its preference for regulatory forbearance on the local government debt issue, and the CBRC – once again, as a dependent regulatory authority – followed the government. The political assets produced by regulatory forbearance in the case of local government debt outweighed the risks of regulatory failure for the central government. The incentives not to fix the local government debt problem were greater for the "principal" and bank managements, which were in a period of flux. The CBRC had to follow along with the collusion among the central government and the local governments by taking accommodating regulatory actions. Once again, the principal favoured the banks and their clients despite the risks pointed out by the supervisor.

Wealth-Management Products

The growing amount of wealth-management products offered by banks in China is another source of risk for the banking system. The interest rate controls in the country cause investors to shy away from banks and look for higher real returns in other markets. To attract investors, banks often offer unregulated or lightly regulated financial products that can be kept off of balance sheets and offer better returns for the investors. The value of these products in the Chinese banking system reached 13 trillion CNY – 14.5 per cent of total banking deposits – by the end of 2012, according to Fitch Ratings. Official numbers, however, suggest that the value of wealth-management products in the banking system increased by 15.5 per cent in the first quarter of 2013, reaching 8.2 trillion CNY (Xiao 2013). This rapid rise in wealth-management products can be explained, first, by the fierce competition among banks to increase their market share

and by the pressure on bank employees to reach growing sales targets each month. Second, customers seeking slightly better returns than the bank deposit rates, reassured by positive stories from their friends, family members and neighbours, show a huge interest in these products. Considering that a Chinese customer will receive 2.85 per cent interest on a three-month deposit, while a wealth-management product can offer between a 4 and 5 per cent return for a one-month or an even shorter-term investment, wealth-management products are quite attractive. Last, besides individuals, more and more public companies are using wealth-management products as investment vehicles (*Caijing* 2013).

However, the projects and assets involved in these products are not always transparent or risk-free, putting investor funds at risk. At the end of 2012, a group of small investors found out that their investments tied to a wealth-management product, marketed by a commercial bank, were lost. It was revealed that the dodgy companies that received investors' funds misused them and defaulted. The bank did not accept any responsibility for the losses of its customers and left them to pursue action against the companies on their own (Shen and Li 2012). Another potentially serious risk is the maturity mismatch between the interest payments of the short-term wealth-management products and the long-term payback structures of the projects the funds are lent to. Banks paying wealth-management products' interest payments with deposits from the sales of new wealth-management products is actually a Ponzi scheme.

The risks associated with wealth-management products in China are often overlooked by bank customers looking for better returns for their hard-earned savings. The risks are also expressed casually by the bank staff, who are often under pressure to reach sales targets. Some banks even ask their loan-seeking customers to buy wealth-management products as a condition of loan approvals. The quality of the assets and the rate of growth are especially alarming in smaller and regional banks, which try to compete with larger commercial banks in attracting customers. The CBRC initially rebuffed the need to regulate wealth-management products, because they were affecting a very limited number of wealthy individuals. Later, Chinese consumers lacking the funds to qualify to invest in these products became innovative. They started gathering funds privately from colleagues or family members but bought the product under one name (Soh and

Flaherty 2012). With similar innovations, wealth-management products have become widely available in the market, and small investors have become vulnerable, too.

Unlike half-hearted regulatory efforts in the cases of Wenzhou and LGFPs, the CBRC's approach to wealth-management product regulation has been swift. The CBRC issued stricter regulations to prevent banks expanding their wealth-management products and hiding the risk (CBRC 2013). Banks were also warned not to withhold information from their customers about the risks associated with the products they purchase. The banks were even asked to record their sales processes on video to prove that they have adequately informed their customers about the risks involved with the products (CBRC Shanghai Branch 2013). As a result of this vigorous regulatory activity, it became harder to sell wealth-management products. The products with high risks and high returns had to be transformed into moderately risky products. One bank manager from Beijing had this to say about sales of wealth-management products:

> Last year or even in the first half of this year, I was embarrassed to call a product with less than a 5 per cent return a high-yield product. Now products with more than a 5 per cent return are very rare (Jin 2013).

With stricter regulations, the number of wealth-management products offered by banks has also decreased.

In the case of wealth-management products, the CBRC was much more assertive and used its regulatory capacity decisively, unlike in the previous two cases discussed in this article. This can be explained by the central government's low level of interest in the issue, as wide-scale rent distribution was absent. However, regulatory failure could increase the risk of political instability if investors suffered huge losses. The central government, in the case of wealth-management products, favoured strong regulation, allowing the CBRC to take tough regulatory action. When the principal's objective of maintaining social stability was in line with the supervisor's mandate of less risk-taking in the banking sector, the agents were unable to capture the regulatory process. The non-existent regulatory framework for wealth-management products has been primarily shaped by the principal and supervisor. Banks as agents had to adjust their practices according to those preferences.

Conclusion

Comparing the three cases of financial risk management by the CBRC, we can conclude that the CBRC's approach to fulfilling its obligation to oversee the stability of the banking system varies depending on the actors involved and the central government's policy objectives. As Table 1 illustrates, when the central government is highly interested in the issue and sets its preference for lax or strong regulation, the CBRC follows the principal's lead. In the Wenzhou mini-crisis, although the CBRC wanted to continue its prudent approach to supervision, the central government's intervention pushed the CBRC to become more lenient towards banks. In the case of loans to local government platforms, despite the CBRC's efforts, both the local governments and the banks circumvented regulations and gained the central government's tacit approval to do so. In regulating the wealth-management products, although the CBRC faced challenges from the banks to its regulatory authority, it was able to push back and exert strong control regarding these products. Unlike the previous cases, the involvement of depositors and the rise in their numbers pushed the CBRC to act decisively. The possibility of social unrest created by victims of shoddy financial products has given the CBRC an extra incentive to act promptly. The central government supported strong regulatory action and the CBRC's approach, although subsequent political gains were low.

Table 1: Regulatory Behaviour of the CBRC

Issue	Government Interest	Government Preference	Regulatory Behaviour
SME Lending	High	Lax Regulation	Regulatory Capture
Local Government Debt	High	Lax Regulation	Regulatory Forbearance
Consumer Protection	Low	Strong Regulation	Regulatory Action

Source: Authors' own compilation.

The CBRC and its staff cannot act independently, as they have to follow policy guidelines and signals from the party leadership to keep their current jobs and secure prestigious promotions in the future. On the other hand, the CBRC is not completely captured by bank

interests and tries to keep its scorecard good in terms of preventing banking crises and sharp rises in NPLs. The agency also pushes for the adoption of international regulatory standards such as Basel III in an effort to keep the banking system stable despite the government's intervention.

Overall, the principal-supervisor-agent model in China is not producing efficiency-increasing regulatory outcomes; instead, it is creating accommodating policies for the banks and the central government. The risks associated with banking activities are forwarded to future bureaucratic cadres, while the banks continue their operations under an implicit bail-out guarantee from the central government. The principal and the agents collude when the principal's objectives other than regulatory prudence are given priority. The CBRC, as the supervisor, acts with limited authority and selectively supervises the banking industry, complying with demands of the principal and its mandate. Banking regulation in China illustrates the Chinese regulatory state model in which one-party rule weakens regulatory capacity yet provides political outcomes favourable to party members involved as principals, supervisors or agents. Hence, the CBRC is a dependent regulatory authority which has to perform well in order to survive despite the constrictions presented by the political institutions surrounding it.

Although no cases of collusion between the agents and the supervisor were presented in this paper, information asymmetries and political patronage – especially at the local level – carry a risk that the banking sector problems will be concealed from the state. This risk, however, is diminished as the new leadership views the banking sector risks as too big to ignore. The central government is watching the CBRC and the banks more closely and seeking more information in regards to their activities, which is decreasing the information asymmetry between the principal and the supervisor. Once heightened awareness of banking sector risks subsides and bank regulation slides out of the government agenda, we can expect the risk of collusion between the supervisor and agents to reappear.

The principal-supervisor-agent framework in China is reproduced within the institutional settings of the country's political system. The local–centre dichotomy and the hierarchical relationships are sustained while the information asymmetries between the parties increase or decrease depending on the performance requirements of

the principal from the supervisor and the agents. Within the P-S-A framework, the central government enters into separate contracts with the supervisor and agents, allowing it to demand different regulatory outcomes from each contract when necessitated by political objectives. The contractual outcomes favoured by the government are accepted by both the supervisor and the agents. Further research should thoroughly investigate the P-S-A framework and its characteristics, which have been shaped by Chinese political institutions in other regulatory areas in which the government delegates its authority to bureaucratic organizations.

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