

# The Chinese Banking System

Weirong Yan



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Weirong Yan

# CHAPTER 1

## INTRODUCTION

The topic of the Chinese banking sector reform has received considerable attentions from domestic and international academicians, business practitioners, and Chinese policy makers in recent years, especially since 2001, when China officially became a World Trade Organization<sup>1</sup> (WTO) member. This milestone occurred following 15 years of negotiations, which were initiated in 1986 with its application for resumption as a GATT (the General Agreement on Tariffs and Trade) contracting country<sup>2</sup> (Dobson & Jacquet, 1998). The WTO

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<sup>1</sup> The GATT originally referred to as 1947 General Agreement on Tariffs and Trade, providing the basic rules for the multilateral trading system from January 1, 1948 until the WTO (the World Trade Organization) was established on January 1, 1995. Since then the GATT was amended and incorporated into part of WTO agreements. The main difference between the GATT and the WTO is that the GATT only deals with trade in goods, and the WTO covers not only trade in goods, but also trade in services (GATS) and trade related aspects of intellectual property (TRIPS) (See the WTO official website: [www.wto.org](http://www.wto.org)).

<sup>2</sup> China was one of the 23 original contracting parties of the GATT in 1947; however, it did not participate in GATT activities for more than 30 years since the Chiangkai-Shek Government withdrew from the GATT in 1950 after it retreated to Taiwan. In 1986 the People's Republic of China started to apply for the resumption of its GATT membership. In April 1989, the Working Party Meeting of the GATT was about to work out the final terms of protocol for China's resumption of the GATT seat, however, due to the Tiananmen Square incident that occurred in June 6, 1989, the China's resumption process was delayed. Though China's GATT negotiations regained some momentum in the early 1990s, however, the large trade surpluses with the US and the human right issues made the US and other Western countries more demanding, as a result, China failed to

membership requires China to completely open its banking sector to foreign banks within 5 years of its accession (see Table 5.2). In other words, effective early 2007, China is required to abolish all geographic, client and business scope restrictions on foreign banks, and grant foreign banks national treatment so that foreign banks can compete with Chinese domestic banks on a level playing field. The growing presence of foreign banks in China in recent years has raised an important policy issue for the Chinese policy makers: is the Chinese banking sector ready to compete with foreign banks on an equal footing?

To answer this question, the present research examines the Chinese banking system reformation process as it has occurred in China over the past two decades. It begins with the pre-reform period and continues through to the most recent period. This research then focuses on the three most challenging issues facing the Chinese banking sector at the present time: the non-performing loans (NPL) problem, governance and related ownership issue and foreign bank entry. This research also examines the French banking sector privatization experience of the last two decades, and identifies implications for the Chinese situation.

The Chinese banking system has received considerable research attention in recent years. However, much of this literature has focused on the institutional transformations of the Chinese banking system over the reform period. In contrast, very few studies have examined China's pre-reform banking system, perhaps because researchers may have viewed it as being too rudimentary to warrant discussion and the difficulty associated with conducting research on that topic during that time period. Thus, one purpose for this research is to reex-

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resume its GATT membership before the WTO, replacing the GATT came into being on January 1, 1995. And then China had to request the conversion of the Working Party to consider the terms of accession to the WTO. After negotiations with the US and other Western countries years after years since then, finally on November 15, 2001, China was officially admitted as a WTO member.

amine the pre-reform banking sector by analyzing available data and materials in order to enhance the understanding of China's banking sector reform and legacies remaining in the current banking system. An examination of the main features of the pre-reform banking system serves to provide insight into issues facing the current Chinese banking sector, and offers suggestions regarding possible future reform directions.

Previous research concerning the causes of China's non-performing loan (NPL) problem has suggested that it is largely the combined result of: the government intervention, especially in form of policy lending (e.g., Lin & Tan, 1999); the weak financial performances of the state-owned enterprises (e.g., Lardy, 1998; Watanabe, 1999; Mo, 1999; Bonion & Huang, 2001); and the failures in the banks' management (e.g., Lu et al., 2001). However, the excessive NPL levels associated with the Chinese banking sector may be a manifestation of more fundamental problems dealing with governance and the related ownership issue at state-owned enterprises (SOEs) and the state-owned commercial banks (SOCBs). The majority of this literature has overlooked the SOCBs' ownership problem, thus part of this research attempts to fill in this gap.

Corporate governance issues have been extensively studied in China since the early 1990s, when the corporate governance concept was first introduced from the West. However, the literature has tended to focus on the corporate governance issue of state-owned enterprises (e.g., Wu, 1994; Zhang, 1997; Lin, C., 2001; Tenev et al., 2002; Tian & Estrin, 2005; Xu et al., 2005) while ignoring that of the Chinese banks. The present research assists in filling in this gap. Using the corporate governance conceptual framework of firms, the governance problems that continue to plague the Chinese banking sector (especially the state-owned commercial banks) are carefully examined. Based on the theoretical discussion of the corporate governance issues of Chinese banks (especially those relevant to the state-owned commercial banks), this research argues that state ownership or state concentrated

ownership of Chinese banks may be the primary factor contributing to ineffective corporate governance in the Chinese banking sector. In order to reduce political and agency costs, and solve the insider control problem facing the state-owned commercial banks, privatization may eventually be necessary for the establishment of effective Chinese banking corporate governance (Zhang & Yi, 1997) with the market supporting institutions, such as the rule of law. For this purpose, the current reforms, such as adopting the standard corporate governance structure, inviting foreign banks to hold bank shares, listing in the domestic and international stock markets, and strengthening the banking regulation and supervision are essentially on the right track. However, to assist private sectors in more efficiently monitoring bank managers, the government may need to consider gradually ceasing involvement in banking activities, while shifting their focus to a rule-setter and regulatory role.

Despite the growing presence of foreign banks in China, the topic of foreign bank entry into the Chinese market has received limited research attention. Most of these studies have focused on the impact of foreign banks on the Chinese domestic banking sector (e.g., Lin, 2001; Lardy, 2001a) while very few studies have examined the motivations driving these banks to enter the Chinese market. In fact, a thorough literature search revealed that a study by Yan (2001) is the only published study investigating foreign banks' Chinese market entry motives. Yan (2001) argued that the primary Chinese market entry motive is the continued service of existing home customers. However, Yan's argument may have been more valid prior to the mid-1990s, since that time a number of changes have occurred in the Chinese financial environment. In the present research, to further examine the motive of foreign banks' entry in the Chinese banking market, foreign banks' internet homepages were examined and telephone in-

interviews with foreign bank branches<sup>3</sup> were conducted. Based on the results of the telephone interviews with those foreign bank branches located in Beijing, Shanghai and Dalian, it was found that the majority of foreign banks in China (e.g., from North America, Europe and East Asia) entered the Chinese banking market primarily for the purpose of servicing their home clients, but also for seeking for local business opportunities (see Table 5.6). In particular since China's accession to the WTO, foreign banks especially from the USA, Singapore, Hong Kong, the UK and Germany are more aggressive than the banks from Japan and France in seeking for Chinese local market opportunities and expanding their market share in China. While admittedly some foreign banks continue to concentrate their efforts on servicing home clients, a large number of foreign banks from a variety of countries are presently in the process of aggressively pursuing Chinese local market opportunities and profits. This finding also supports the study results conducted by Miller & Parkhe (1998), Seth et al. (1998), Focarelli & Pozzolo (2000), Clarke et al. (2001) and Claessens et al. (2001b) regarding foreign bank entry in the developing countries: due to financial globalization and deregulation of the domestic financial sector, local market or profit opportunities may have been driving foreign banks' expansion to foreign markets especially in regards to the developing countries. Perhaps, this is one of the contributions this research made to this field.

This research also examines the French banking sector privatization process occurring during the past two decades, and analyzes its factors, approaches and results and discusses implications for Chinese policymakers. This study contributes to the literature by serving as the first study to compare and contrast the French and Chinese banking sectors. The present

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<sup>3</sup> Telephone interviews with 30 foreign bank branches were approached in February 2004 and from December 2004 to January 2005, however, 15 of them refused to participate. Thus, 15 usable telephone interviews with foreign bank branches completed. The participating foreign banks were based in North America, Europe and East Asia (see Table 5.6).

day Chinese banking system faces many of the same problems faced by the French banking system in the early 1980s and the 1990s. This suggests that the study of the French banking successful privatization experience in the past two decades will likely provide significant insights and lessons for the Chinese banking sector policy makers.

This research consists of seven chapters. Chapter 2 consists of an examination and analysis of the Chinese pre-reform banking system based on available materials and data and also an overview of the Chinese banking reform process occurring during the past two decades.

In this chapter it is found that the pre-reform mono-bank banking sector did not effectively perform its basic functions as a financial intermediary, rather acted as a governmental fiscal agent. From the fundraising side, the savings were mobilized almost entirely within the government sector prior to the reform (Lardy, 1998). For example, the government sector accounted for 73 percent in 1978, while the household savings rate was only 14.9 percent (see Table 2.1). The low household savings rate and small source of household deposits also extremely constrained the pre-reform banking sector to play an efficient intermediary role in the Chinese economy. Additionally, from the lending side, the pre-reform banking sector did not perform an intermediary role effectively during those years. The majority of long-term investment and financing was not allocated to enterprises through the banking sector, rather through the state budget (Shang, 1999). The banking sector was only responsible for providing a small proportion of working capital for enterprises where deemed necessary (Zhang, 1998). Furthermore, the limited role of the banking sector was also reflected in the simple institutional structure of the pre-reform Chinese banking sector. The pre-reform banking system is called a mono-bank system because there was only one bank, the People's Bank of China (PBC) essentially in the banking sector. As a government fiscal agent, the mono-bank, the PBC, under control of Ministry of Finance (MOF) was required to participate in the execution

of the national production plans and adhered to state cash and credit plans (Shang, 1999), thus it had no independence in managing its banking business activities.

Chapter 2 then overviews the Chinese banking reform process in the past two decades and identifies the Chinese banking reform results. The Chinese banking reform process can roughly be divided into three stages. The first stage transpired from 1978 to 1984, the second from 1984 to 1993, and the third from 1993 to present. In the past two decades' reform, substantial improvements have been made in the Chinese banking sector. First, China successfully transformed its rudimentary pre-reform mono-banking system into one that is more comprehensive, diversified and sophisticated. The new system consists of the central bank, four state-owned commercial banks (SOCBs), three policy banks, 12 national and regional joint-stock commercial banks, 90 city commercial banks and numerous non-bank financial institutions (see Table 2.5). Foreign banks have also become an integral part of the Chinese banking sector. Second, during the reform period, China has progressively done away with its heavy dependence on budgetary investment financing that was typical of the pre-reform period. The Chinese banking sector, instead, has increasingly replaced the state budget in playing the leading role in financing for investment in the Chinese economy (Girardin, 1997). Third, the economic reform also has transferred the low-cost government savings to high-cost household and enterprise deposits. Consequently, the banks in China have increasingly restored their financial intermediary functions in terms of fund-raising or deposits. Fourth, competition has been gradually introduced and enhanced in the Chinese banking sector during the past two decades. The Chinese banking market has become increasingly competitive, especially with respect to the growing presence of foreign banks in China occurring after China's accession to the WTO in 2001.

Despite these substantial achievements, the Chinese banking sector remains relatively inefficient and uncompetitive

compared with those of the most of developed countries (e.g., Lardy, 1998; Lin., 2001). For example, in terms of the lending, Chinese banks remain generally ineffective at selecting and monitoring their borrowers. With the help of the government funding infusion, the average NPL level of the big four state-owned commercial banks that has been reduced at 7.5 percent of total portfolios according to the China Regulation Commission (2006), is still high by international standards. The Chinese banking landscape continues to be dominated by the big four state-owned commercial banks (SOCBs), the Industrial and Commercial Bank of China (ICBC), the China Construction Bank (CCB), the Bank of China (BOC), and the Agricultural Bank of China (ABC), which account for more than half of the sector's total assets, loans and deposits (see Table 4.1). Moreover, the state retains ownership and controls the majority share of the Chinese banking sector. State domination and high level of concentration appear to be negatively affecting the efficiency and competitiveness of the Chinese banking sector. Thus, the Chinese banks' future effectiveness in an increasingly competitive banking market requires these challenges (e.g., the problems with NPL, governance, state ownership, and foreign bank entry) to be effectively confronted.

Chapter 3 focuses on the Chinese banking sector's non-performing loan (NPL) problem and its causes, especially those involving the four SOCBs. The scale of the NPLs at the Chinese banking sector was so daunting in the past decade that it has drawn much attention from government officials and academicians. These officials and scholars differ in their estimation of the magnitude of the NPLs in China's banking sector, especially in the four state-owned commercial banks (SOCBs), however, the high NPL ratio indicates that the Chinese banking sector was extremely vulnerable, inefficient, highly challenged by this issue.

In the previous literature, basically there are two schools of thought concerning the causes of the NPLs at the Chinese banking sector. One school (e.g., Qian, 1994; Fan, 1998; Lin.,

1998; Lin & Tan, 1999) argues that government intervention, in its various forms, especially in the name of policy lending, is one of main sources of China's NPL problem. They argue that the separation of policy lending from commercial lending at the state owned commercial banks would solve the NPL problem. In contrast, the other school (e.g., Lardy, 1998; Watanabe, 1999; Mo, 1999; Boinin & Huang, 2001; Lo, 2004) contends that the NPL problem is more closely linked to the weakening SOEs, which was negatively affected by a broad range of social burdens the state forced on SOEs. When firms were unable to service their debt, those social burdens were mostly transferred to the banks, especially, the state owned commercial banks, leading to a large amount of the NPLs (Lardy, 1999). They suggest that the key to solving the NPL problem is the rectification of the triangular relationships among the government budget, the state-owned commercial banks and SOEs. Clearly, there is considerable merit to this argument in the previous literature. However, the previous literature did not go sufficiently far enough to dig out the fundamental factor behind government interventions and SOEs' social burdens: the state ownership problem. This chapter argues that the only way to end government interventions, and eliminate SOEs' policy burdens that caused the NPLs at the Chinese banking sector, is to reform the ownership of SOEs and the banks, particularly the Big Four<sup>4</sup>. Meanwhile, policy or social burdens need to be taken care of by the government fiscal budget. In other words, privatization of the state-owned commercial banks and SOEs, and separation of fiscal functions from the banks perhaps are the viable long-term NPL solutions.

Chapter 4 analyzes the governance issues facing the Chinese banking sector by using the corporate governance conceptual framework and suggests that the Chinese state-owned or

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<sup>4</sup>The big four is referred to as the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the China Construction Bank (CCB) and the Agricultural Bank of China (ABC).

state-controlled commercial banks<sup>5</sup>, which dominate the Chinese banking sector, have suffered from political and agency costs, insider control issue, and associated ownership problems during the reform period. The current banking reform that includes introducing the standard governance structure in the big four state-owned or state-controlled commercial banks, inviting foreign banks and private sectors or individuals to invest in the Chinese domestic banks, and listing them in the domestic and international stock markets appears to be headed in the right direction. However, with the state holding a controlling share, the banks will likely continue to be influenced by the government's interests. This new arrangement of the ownership and governance structure for the Chinese banks will probably be very challenged in solving the political control and agency problems, and may actually contribute to the emergence of a new governance issue: insider control. Thus, further reform may require the government to exit corporate governance or state ownership involvement in the banking sector. In other words, privatization of the state-owned commercial banks may be necessary when the market supporting institutions, such as the rule of law, are well-established and enforced. Without government involvement or interventions, the agency problem may be more easily addressed; and the relationship between firms and banks maybe be easily established on a normally commercial basis. In order to enhance the private sector's facilitation of efficient bank managers monitoring, the Chinese government perhaps needs to consider playing an increasingly important rule-setter and regulatory role. In doing so, it may nurture a fair competition market, as well as the establishment and enforcement of legal, bankruptcy, and regulatory systems in the banking sector.

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<sup>5</sup>The BOC, ICBC, CCB and ABC were wholly state-owned commercial banks before 2003; however, BOC, ICBC and CCB became joint-stock commercial banks, in which foreign investors hold a minority share while the Chinese state holds a majority stake (see Table 5.10). The ABC is still wholly state-owned commercial banks.

Chapter 5 examines the motives of foreign banks entering the Chinese domestic market and their impact on the Chinese banking sector over the past two decades. As an integral part of Chinese economic reform and open door policy, the process of opening up its banking market has generally been gradual and cautious (Liu, 2001). The opening process occurring during the past two decades can be divided into three stages: (1) the late 1970s to the early 1980; (2) the mid-1980s to the mid-1990; and (3) the late 1990s to the present. During the first stage, foreign banks were limited to opening representative offices, first in Beijing, and then in the Special Economic Zones (SEZs), and gradually sub-representative offices in certain designated cities. Representative offices could represent their parent banks, engaging in consulting, liaison and market research, providing market information on the Chinese economy for their clients outside China, and also offering advisory services for their clients in China (Richard, 1988). However, they were strictly forbidden to conduct any profitable banking business activities. During the second stage, foreign banks were allowed more freedom, but the environment was still heavily regulated. They were permitted to set up operational branches, first in the Special Economic Zones (SEZs) in the mid-1980s, then Shanghai in the early 1990s, and later in other coastal cities in the mid-1990s (Dipchand et al., 1994). Although the geographic restrictions on foreign banks were gradually relaxed in this stage, the environment, in terms of client and business scope, remained heavily regulated. For example, foreign bank branches were allowed to only do foreign exchange business with foreign-invested enterprise (FIEs), foreign individuals, and overseas Chinese. They were also prohibited from doing any Chinese local currency business. During the third stage, regulations on business scope, client and locations were further relaxed.

It is evident that China has been opening its banking market gradually, starting with the economically developed coastal areas and spreading to its less developed inland areas. With the rapid economic growth experienced by China since the

mid-1990s, especially after the WTO accession, the pace of opening its banking market to foreign banks has quickened dramatically. The restrictions on geographic, clients and business scopes are in the process of being gradually removed.

In the early stages of China's banking sector opening, foreign banks were barred by Chinese governmental regulations from pursuing domestic markets. Thus, these banks focused their efforts on servicing home clients with Chinese business operations. However, with China's banking market becoming increasingly accessible to foreign banks since the mid-1990s, many foreign banks are now in the process of aggressively pursuing the market opportunities and potential profits associated with these previously forbidden domestic Chinese markets.

The motives of foreign bank entry (i.e., aggressively pursuing the Chinese domestic market opportunities and potential profits) and increased presence of foreign banks in the Chinese banking marketplace since the mid-1990s may actually benefit the Chinese banking system by introducing more competition and assisting in the Chinese banks' ownership and governance structure reform, thereby increasing efficiency and profitability. On the other hand, because these foreign bank entrants possess competitive advantages, they will likely prove formidable competitors in the potentially profitable Chinese domestic banking market. This in turn may relegate the Chinese domestic banks to the more uncertain role of serving riskier and less desirable customers (Montgomery, 2002). To minimize these likely risks and negative effects, it is suggested here that Chinese policymakers consider establishing an efficient, market-oriented, and competitive commercial banking system, with effective governance and advanced management skills. In order for this to occur, an acceleration of the ownership structure reform process in the context of the state-owned commercial banks is imperative.

Chapter 6 examines the French banking sector privatization process, and analyzes its factors, approaches and results, and finally identifies some implications for the Chinese policy-

makers. The French banking sector privatization process can be roughly divided into two major stages: (1) the 1980s; and (2) the 1990s. The French banking sector privatizations in these two decades were driven to varying degrees by both internal and external pressures. The first French banking privatization stage was influenced primarily by domestic factors, such as political ideology and the state budget deficit (Ducruzet & Papadacci, 1992). In contrast, the second stage tended to be more strongly influenced by external factors, such as the growth of EU driven banking competition, European monetary unification and global financial liberalization (Oyama & Narimou, 2002).

While the two stages of French banking privatizations were both large scale and ambitious, they were fundamentally different. The first privatization stage was designed to simply return state banks (especially previously nationalized commercial banks) to the private sector. In contrast, the second privatization stage was broader in scope, more complex and cut deeper. It not only privatized the remaining state owned commercial banks, but also privatized the other types of state banks such as cooperative banks, savings banks, policy banks and other public financial institutions. Both of these privatization stages have substantially impacted the French banking sector. The privatization of the French commercial banks in the 1980s began to introduce competition into the French banking sector, which pressured the remaining state banks to adjust their management philosophies towards profit-making. In contrast, the banking privatization of the 1990s not only continued to return banking capital from the state to private sectors, but also deeply restructured the banking sector institutionally, reshaping the banking ownership structure from state to private ownership.

The virtual disappearance of state ownership has dramatically altered the French government's banking role. The French banking sector has increasingly become a more market and profit oriented, institutionally sophisticated, efficient, competitive, and modern banking system. As a result, its per-

formance has improved remarkably that it is now on par with many of its European and American counterparts.

Despite undergoing substantial changes during the past twenty years, including an initiation of the banking privatization process, the Chinese banking sector remains largely under state control. In fact, the state presently owns and holds more than 90 percent of the banking assets and deposits in that nation. This situation is very similar to that of the French situation prior to its first privatization stage that occurred in the mid-1980s, when 98 percent of deposits were held by the state owned banks (see Table 6.2). In other words, although the Chinese banking sector has undergone a series of reforms and partial privatizations during the last two decades, its ownership structure has remained fundamentally unchanged, and the Chinese banking sector still has performed the governmental fiscal functions to some extent. While the Chinese government has sold off minority ownership stakes in certain major Chinese banks to foreign banks, it still retains a majority stake in these banks. This partial privatization strategy is potentially risky. As long as it retains a controlling share, the state will likely exert its non-commercial influence on bank management and strategy. It would likely do this by providing public finance, such as offering subsidies to failing SOEs, impoverished areas, priority industries, or other social welfare programs through the banking sector. If this situation is allowed to persist indefinitely, the Chinese banking sector will be likely continue to suffer from new non-performing loans occurring from public financing.

One of the key factors positively impacting the French banking privatization was the French government's willingness to disengage from the banking sector, and move towards greater involvement in the nurturance of private banks and of a competitive banking environment. The French banking experience suggests that the transfer of ownership and control from the state to the private sector may enhance bank performance. This likely occurs because private managers and shareholders have greater profit maximization incentives.

France's successful banking sector privatization effort supports the idea that China should proceed in its push towards banking sector privatization. This could be facilitated by a gradual divestiture of its majority state ownership share to institutional investors (foreign and domestic), bank employees and individual investors. The government's role as a minority stake holder will limit its bank management influence. Thus, the bank will be able to operate its banking business on a commercial basis.

Presently, the transfer of the ownership and control of the big four state commercial banks from the state to the private sector will significantly impact the Chinese banking sector as these banks dominate the banking landscape, accounting for over half of the total deposits and assets in the banking sector (Table 4.1).

On its path to banking privatization, it is recommended here that policy makers follow the procedures used by France when it privatized publicly-owned financial institutions (state banks). Specifically, commercial banking should be separated from public financing in the state owned banks, while working towards the elimination of state loan subsidies, and ultimately the complete privatization of the banking sector. In the case of the big four, China took a step in that direction in 1994 when it established three policy banks in a move designed to relieve policy lending responsibilities from the big four. However, it appears that China did not go sufficiently far, as the state continues to use the big four to provide public financing such as subsidized loans and policy loans to failing SOEs, state priority projects and impoverished areas. The French experience suggests that by ceasing to use the nation's banking sector for public financing functions assisted that country in creating a fair competition environment in its banking sector. As a result, French banks are becoming increasingly market-based, profit and efficiency-oriented. Thus, rather than using the banking sector for public financing, China should consider managing public financing through its state budget.

The last Chapter ties six chapters together and digs out the logic of the Chinese banking reform policies, and finally ends with some conclusions.

The French experience in banking reform suggests that elimination of the banking sector from performing public financing functions assisted the country in creating a fair competition environment, leading to the efficiency of the banking sector. That would likely apply to the case of China. In order to manage public financing well through the state fiscal budget, the tax reform in China is needed to increase the state fiscal revenues.

The present Chinese banking sector situation is more complicated than that of the French banking sector during its transformation process, making the pure privatization of the Chinese banking sector appear impractical. In order to help the Chinese banking sector to efficiently compete with foreign banks, China needs a more comprehensive or coordinated approach in dealing with its banking sector challenges. While pushing for the ownership structure reform of the Chinese banking sector, and further nurturing a reasonable and competitive banking environment, the Chinese policymakers may also need to focus on the establishment and enforcement of its market supporting systems (e.g., legal, regulatory, bankruptcy) to protect private property rights. With abundant fiscal revenues, it would make the Chinese government easier to manage the public financing, and cope with the risks and costs of the banking sector privatization. With well-established and well-enforced market supporting systems, the fair competition could be possibly conducted, and the smooth privatization of the Chinese banking sector could possibly be achieved.