Relationship banking, Information Economics and Private Monitoring in China

W. Travis Selmier II
Political Science Department
Indiana University,
wselmier@indiana.edu

Keywords: relationship banking, self-dealing, information economics, transaction costs, Guanxi, Chinese banking, private monitoring.

All mistakes are mine and mine alone.

Draft of January 15th, 2013
Please check with me before citing

Acknowledgement: I wish to thank Zhe Feng for her superb research assistance.
ABSTRACT
Criticism directed toward banking in China revolves around self-dealing. Corruption, nepotism, high NPLs and inefficiency of government-directed lending have been blamed on embedded guanxi networks. While valid to an extent, this criticism ignores two important points: guanxi networks bring disciplining mechanisms as well as potential corruption, and those mechanisms may improve banking governance. Relationship banking in a Chinese context- with the influence of guanxi in banking- further increases reputational costs when self-dealing is uncovered.

Employing theory from relationship banking, information economics and the business ethics of guanxi, I present a simple transactional cost argument: costs to bad banking behavior are increasing just as the benefits from staying rich increase. Increased disclosure through private monitoring affects the chances of staying rich as disclosure increases the chances that a corrupt relationship will lead to loss of wealth and reputation.
**Introduction**

A significant amount of the criticism directed toward banking revolves around claims of self-dealing by bankers. Close ties between bankers and their clients have been cited as evidence of corruption and nepotism, and as leading to high levels of non-performing loans around the world (Kane, 2003; Kang, 2002; Rose-Ackerman, 1999). These problems have been laid at the door of Chinese banks and partly blamed on the embedded nature of *guanxi* networks (Cousin, 2007; Shih, 2008). While valid criticism to this point in time, this criticism ignores the positive side of *guanxi* (Li, 2009; Park and Luo, 2001; Su, Mitchell, Sirgy, 2006) and does not recognize that the situation may change. Rather than weakening financial system governance, I argue *guanxi* may begin to strengthen the discipline measures inherent in relationship banking.

This paper examines whether a confluence of factors- the social customs embedded in the Chinese relational system of *guanxi* (Han and Altman, 2009; Huang, 2008; Su, Mitchell, Sirgy, 2006; Yeung and Tung, 1996), information dynamics released through internet and other media channels which wash away informational opacity (Yang, 2009, 2012), and nature of relationship banking (China-specific, see Keister, 2004) - may lead to a better-functioning, better-governed banking system. Mine is a simple transactional cost argument: costs to bad banking behavior are increasing just as the benefits from staying rich increase. As getting rich has become more prevalent in China, the incentive is to stay rich. Private sector monitoring grows as information becomes more available, leading to increased disclosure of bad behavior. While the benefits to staying rich are growing in China, disclosure lessens the chances of staying rich as public knowledge of a corrupt relationship and the resulting shame will lead to loss of wealth and reputation.

Employing theory from relationship banking, information economics and the business ethics of *guanxi*, I argue government difficulty in controlling information flow will lead to greater disclosure of bank-related transactions. I apply Boot’s (2000: 10) definition of relationship banking in this paper: “the provision of financial services by a financial intermediary that: one, invests in obtaining customer-specific information, often proprietary in nature, and; two, evaluates the profitability of these investments through multiple interactions with the same customer over time and/or across products.” Relationship banking in a Chinese context- with the
influence of guanxi in banking and the losses which accrue when bad behavior is discovered—further increases reputational costs.

Guanxi involves significant personal commitment in that the relationship between two parties is supportive and long-lasting, so a debt is created when one party does something for the other (Huang, 2008; Yeung and Tung, 1996). This relational institution helps to overcome resource constraints for both individuals and businesses (Park and Luo, 2001), and may be seen as a bridging function to overcome market inefficiencies due to imperfect or incomplete information.

The “tail” created in this relational binding links both parties; subsequent discovery of ill deeds harms each party by engendering shame, or worse for each (Li, 2009; Su, Mitchell, Sirgy, 2006; Yeung and Tung, 1996). When information is difficult to secret, self-dealing becomes more difficult to hide, and China has entered a period of rapid and extensive disclosure of formerly hidden self-dealing. This disclosure has occurred as the internet leads to a burgeoning civil society (Yang, 2009) which empowers monitoring and criticism (Meng, 2009; Yang, 2012). While the Chinese government may attempt to contain these releases, that capacity is compromised as web users effectively circumvent such attempts (Clayton, Murdoch, Watson, 2006; McKinnon, 2009; Yang, 2009; 2012). Creative use of the web extends the range of criticism to code words, pictures, videos and veiled references (Meng, 2009). Recent internet outings of apparently illicit gain include pictures of officials with multiple expensive watches or in sports cars; maps of multiple apartment ownership; on-line analysis of financials behind large construction projects, and consumption of expensive wine to name just a few (Economist, 2012). Traditional media, both domestic and foreign, are joining in the fray (Barboza, 2012).

Information availability is essential for all markets to properly function. A fundamental paradigm of banking theory is that banks overcome financial market inefficiencies by acting as information conduits. This theory is posited to exist in developed as well as in less-developed markets (Diamond, 1984; Rajan, 1992; Rajan & Winton, 1995; Stallings and Studart, 2006; Winton, 2006). Financial institutions are necessary to move markets tethered to face-to-face, immediate transactions toward transactions which span broader geographic and temporal horizons. Financial intermediation enables capital deployment across both time and space; such deployment requires information transmission by financial intermediaries as well as use of
proprietary information by those intermediaries, which results in informational asymmetries in money and capital markets.

Through intermediation processes, banks disclose information to those who observe banks’ actions and glean information from those actions. Banks may attempt to screen out, withhold, or signal-jam information for their own benefit rather than permit information to flow beyond banks information firewalls (Stallings and Studart, 2005; Reinhardt and Rogoff, 2009; Yosha, 1995). Bank managers may also privately benefit from an informational advantage in their banks, using this advantage for their own financial investments, or seeking to capture revenues through skimming. In addition, state-owned banks may send mixed or incorrect signals when loan-granting is colored by connections, as Bailey, Huang and Yang (2011) argue occurs in China (also see Hsieh and Wu, 2012). Issues of signal quality due to political interference have been documented in many countries (Shen and Lin, 2012). Herein I focus on the problem of bankers’ self-dealing to China in the context of information dynamics and how banking governance may improve through public disclosure.

As explained below, I choose China for many factors. In addition to the relational system of guanxi, there is also an intense interest in tapping into electronic media coupled with increasingly open information flows (McKinnon, 2009; Yang, 2009; Zhou, 2011), a willingness of Chinese people to stand up and criticize when they see bankers and government officials engaged in self-dealing, the prevalence of social fear of being found doing wrong, and a government which, generally, wishes to have a happy (and not revolting) citizen base. While analyzing China, my general concept may be extended to other countries’ banking systems.

This paper proceeds in four sections. The first examines certain fundamental tenets of banking theory, differentiating between relationship and transactional banking and introduces Chinese banking through the theoretical lens they provide. The second continues this analysis of the Chinese banking industry with a focus on relationship banking and guanxi networks. The third applies ideas of modern informational dynamics into this banking theory framework, setting down a theory as to why I expect private monitoring will become more effective in Chinese banking. The fourth notes limitations in this approach, and offers ways to empirically test these ideas.
I. Relationship and Transactional Banking, and their Pathologies in Chinese Banking

Banks are said to possess three forms of capital: financial capital, expertise (including tacit knowledge), and reputational capital (Boot, Greenbaum and Thakor, 1993; Hidy, 1941: 58; Morrison and Wilhelm, 2004). Financial capital, of course, is the bank’s underlying capital stores. Possessing reputational capital enables a well-regarded firm to leverage and increase its financial capital in structuring deals, to prosecute business while running higher assets-to-deposits ratios, and to capture a stronger capacity to garner deposits. Expertise capital is embedded in bank management experience and the ability to financially-engineer complex deals. These forms of capital exist in both relationship and transaction-oriented banking models, but may be utilized in different proportions. It has been argued that expertise capital has become a very liquid, biddable market in a transaction-banking paradigm in that financial engineering skills have made partnership-embedded tacit knowledge less critical to banking operations (Morrison and Wilhelm, 2004; Palmer, 2012; Selmi, 2013).

The nature of banking allows banks to engage in qualitative asset transformation by intermediating between longer-term borrowers, who often seek a longer-term fixed rate instrument and shorter-term depositors, who are often compensated in a shorter-dated instrument (Bhattacharya and Thakor, 1993; Boot, Greenbaum and Thakor, 1993). Banks thereby addressing market failure issues which arise from incomplete information by acting as intermediaries. While banks derive benefits from the asymmetric information sets gathered through their intermediation roles, they also suffer high institutional risks of failure and compromise. As noted below, Chinese state-owned banks may carry an implicit government assurance against failure which lessens their risk profile. Still, such risks exist whether the banks pursue a relationship banking strategy or a transaction-focused strategy.

If we consider Boot’s definition of relationship banking, we see that information must be gathered through a longer-term relationship between banker and client, used in making any credit or financing decision, and protected as confidential to the institutional relationship. In this relationship we can identify three inter-related aspects:

- The passing of certain information is restricted to a privileged channel between the client and the bank(s) she most trusts;
• That bank obtains an asymmetric information advantage in financial contracting in that it is in possession of the resulting unique dataset which passes through this channel;
• The resulting bank relationship is more likely to last, to be deeper, and broader (that is, transaction costs are lowered by way of the tacit, soft data captured in the relationship and then used in credit and capital allocation decisions).

Relationship and transactional banking are archetypal forms of banking in that these concepts have been reified in the banking finance literature. Actually, relationship banking does not exclude hard data per se, but rather must include data analysis often ascribed to realm of transaction-oriented banking (see Boot on securitization, 2000: 11-12). While the practice of relationship banking still necessitates utilizing “numbers,” practicing transaction-oriented banking may require little beyond point-of-transaction relationships in that the point of banking activity focuses on that transaction core rather than peripheral, softer data which require relational intensity developed through temporal length.

We might conceptualize these two archetypal forms of banking as a continuum in which pure transactions-oriented banking empowers financial analytics as the relationship aspect of the banking is removed—leading to the creation of arms-length banking—while relationship banking must include some analytics or we would simply call such activity naïve lending, or even gifting.

In both cases there are substantial information search costs, as well as the costs associated with information capture, storage, usage and transmission. The resulting investment requirement in
relationship banking operations is considered both large and asset-specific to the relationship, and it is assumed that smaller banks have an advantage in controlling such costs while maximizing the benefits when engaged in small and medium enterprise (SME) lending. This leads to the eponymous “small bank advantage” (Berger and Udell, 1992,2006; Boot and Marinč, 2008: 1190-1; Zhang, 2002) and are a foundation of relationship banking. However, the idea that these information costs dynamics, leading to a small bank advantage in SME relationship lending, when reversed lead VLFIs (Very Large Financial Institutions) to engage solely in transactions-oriented banking is not an entirely accurate way to look at the issue. Even in highly transactions-oriented environments, a strong relationship still exists (Boot, 2000; also see Williamson, 1985, for his small-numbers transactions model, for instance). As a banking example, consider the intensely relational aspects of corporate finance and advisory work. Although it has long been known that a significant capital is required to become and remain a VLFI with investment banking operations (Hayes, 1979), there remains a clear and present importance of relationship banking in much of investment banking. As I argue below, Chinese VLFIs hew more closely to a relationship banking model in part because longer-term relationships are embedded in Chinese financial contracting.

We can argue there are advantages and disadvantages in relationship banking and transactional banking. In relationship banking (Boot and Thakor, 1993; Rajan and Winton, 1995):

- deeper information held by bank may lead to better capital allocation decisions, as the client is willing to selectively disclose to her primary bank(s) so as not to leak information to competitors to see;
- The capacity for financial contracting is not just simply an ex ante proposition, but carries ex post advantages as well.
  - Given that financial contracting occurs under bounded knowledge, it is not possible to include all the contingent clauses which may prove necessary over the life of the financial contract.
  - Known risks are included in credit pricing, but uncertainty is present at the time of contracting. Although forecasting of future events may be probabilistically estimated, the distribution probabilities are based on known risks.
  - Relationship banking allows for significant negotiating latitude ex ante due to the inherent trust in the relationship.
- Covenants are easier to negotiate and collateral monitoring more effective under relationship banking.
In transactions-oriented banking:

- Reliance on hard information ameliorates mistakes which may arise through human error or, more critically, human bias toward or against a particular borrower (Zhang, 2002);
- A uniform analytical approach
  - Brings a statistically-stable approach to the credit allocation/capital commitment decision
  - Creates capacity to do a large number of deals, thereby
    - Lowering transactions costs while
    - Enabling a portfolio approach which is more difficult to achieve under a relationship banking model.

Each archetypical banking model brings certain pathologies as well. One might argue that the advantages which each offer have a dark side. As summarized in the table below, relationship banking’s relationships may literally be too close, leading to over-commitment to a borrower, and inefficient budget constraints or, more likely, laxity. Chinese banking analysts term this issue of the “soft budget constraint” as one of “lending new to repay old” (Cousin, 2007: 88. “借新還舊”). This close relationship may also cause a hold-up problem in which the bank is able to hold hostage a client who has committed in a main banking relationship with that bank and has nowhere else to turn, particularly for smaller firms. Cousin (2007: 106-9) cites Wen (2005) and others who have found Chinese SMEs forced to pay an origination fee, with the China Banking Regulatory Commission (CBRC) investigating cases were SMEs were paying an “application fee” of ~3.8% of loan amount. We might describe the soft-information arising in relationship banking as too tightly held; non-disclosure brings on these issues.

<table>
<thead>
<tr>
<th>Banking Type</th>
<th>Nature of Relationship</th>
<th>Informational Axis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Relational</strong></td>
<td>Too close</td>
<td>self-dealing; commitment to borrower</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Transactional</strong></td>
<td>too distant</td>
<td>Little commitment to borrower, so incentive to monitor now weakened</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 1: Pathologies in Relational and Transactional Banking
Transactions-oriented banking faces the opposite problem: here, relationships may be too distant. The bankers’ monitoring function may be removed, and the banker feels little or even no commitment to borrower. An Economist article summed this up beautifully when noting:

*Old-fashioned mortgage lending is like a marriage: both the bank and the borrower have an incentive to make things work. Securitization, at least in this market, was more orgiastic, involving lots of participants in fleeting relationships. ”* Economist, 2008

We might describe a part of the information stream as both weaker, and dispersed, in a transactions-oriented banking environment. Hard data access remains important in order to achieve an asymmetric information advantage, but now advantage is derived through manipulation and computing power as well.

**II. Chinese Banking structure and relationship banking**

To consider the dynamics of relationship banking in China, we should briefly examine the structure of Chinese banking. The industry is dominated by four banking giants which are majority-state-owned: the Bank of China, the China Construction Bank, the Industrial and Commercial Bank of China and the Agricultural Bank of China (Cousin, 2007; Keister, 2004: 146; Martin, 2012). Table 2 below shows these “Big Four” VLFIs.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Market Capital</th>
<th>State Holdings of Outstanding Shares</th>
<th>Major U.S. Holdings of Outstanding Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural Bank of China (ABC)</td>
<td>$1.019 trillion</td>
<td>83.13%</td>
<td>None</td>
</tr>
<tr>
<td>Bank of China (BOC)</td>
<td>$1.084 trillion</td>
<td>67.53%</td>
<td>None</td>
</tr>
<tr>
<td>Bank of Communications</td>
<td>$398 billion</td>
<td>26.52%</td>
<td>None</td>
</tr>
<tr>
<td>China Construction Bank (CCB)</td>
<td>$1.717 trillion</td>
<td>57.0%</td>
<td>Bank of America – 10.9%</td>
</tr>
</tbody>
</table>
| Industrial and Commercial Bank of China (ICBC) | $1.810 trillion | 70.7%                              | American Express – 0.2%  
                                           |                              |                                     | Goldman Sachs – 4.9% |


*from Martin, 2012: 3*
Greater detail on the Chinese banking sector is shown in data abstracted from Cousin’s excellent industry study (2007) in Table 3 on the following page. As of 2005 YE, the Big Four accounted for over half of total banking sector assets. The balance of bank industry assets are in joint-stock banks (~15% of total banking assets), city commercial banks (<6%), foreign banks (~2%), some 30,000 rural credit cooperatives (>4%), non-bank financial institutions (an unknown amount of banking assets in a somewhat non-transparent sector) and, at the time of writing, three policy banks. While this data is somewhat dated, it still represents an excellent picture of the industry.

Of some importance for our purposes is the nature of loans to state-owned enterprises (SOEs), and which banks are tasked with making such loans. This directly relates to the structure of lending to private firms, whether larger corporations or SMEs. Policy loans were historically tasked to the Big Four and then responsibility passed to the policy banks in the mid-1990s (Cousin, 2007: chapter1, 85, 126-7). The Big Four have retained their ties to the SOEs, and a clear division between SOEs and privately-held companies exists in lending terms (Bailey, Huang and Yang, 2011; Hsieh and Wu, 2012; Yeung, 2009). Except for the very largest privately-held companies, the Big Four ignore private firms and leave them to joint-stock banks and city commercial banks, with SMEs served only by these banks and, for some local firms, sometimes a local credit cooperative or other non-bank financial institution. Foreign banks’ capacity to take deposits is quite circumscribed, and these banks tend to focus on fee-based services, some capital market transactions, and, for some, high net worth individuals and credit card operations.

So what does relational banking mean in a Chinese context? We know that reputation has heightened importance just as capital accumulation and information access and volume are rapidly increasing in China. To tease out the network dynamics of guanxi in Chinese banking, it is opportune to first focus on the challenges of SME’s capital access. Obtaining SME financing is especially difficult in China, where larger banks ignore SMEs and capital markets focus on larger firms. And Chinese banking scholars to date have focused their relationship banking-related research attentions only on SME lending, thus far not examining how the relationship banking paradigm may provide a powerful lens through which to view all of Chinese banking’s unique structures.
<table>
<thead>
<tr>
<th>Banking type</th>
<th>Nick-name</th>
<th>Number</th>
<th>Assets in system (1)</th>
<th>Profitability // NPLs</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-owned Commercial Banks</td>
<td>SOCBs</td>
<td>4</td>
<td>52% of BS assets</td>
<td>ROE: 1.3% to 16.4%</td>
<td>SOCBs are legally enjoined “to provide loans for special projects approved by the State Council. Losses resulting from such loans shall be compensated with appropriate measures taken by the State Council.” Article 41, Common Bank Law (Cousin, 29)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>ROA: 0.02% to 1.03%</td>
<td>NPLs: 3.8% to 26.2%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint-stock Commercial Banks</td>
<td>JSCBs</td>
<td>13</td>
<td>15% of BS assets (2)</td>
<td>ROE: 7.0% to 20.3%</td>
<td>Set up in 1994, these are more entrepreneurial, the most competitive, and a prime target of foreign investment. SDB (case analyzed below) had the highest NPL level and lowest ROE and ROA figures among the 8 banks’ numbers at left.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>ROA: 0.15% to 0.65%</td>
<td>NPLs: 1.3% to 10.6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>City Commercial Banks</td>
<td>CCBs</td>
<td>115</td>
<td>5.4% of BS assets</td>
<td>ROE: 4.4% to 20.0%</td>
<td>Vary tremendously in size, management capacity, degree of political interference, and loan policy. Largest two (Bank of Shanghai and Bank of Beijing) account for 13% and 12% of CCB total assets, respectively. Local governments owned ~75% of CCB shares. All CCB NPL ratio was 11.7% YE 2004.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>ROA: 0.16% to 0.67%</td>
<td>NPLs: 4.0% to 20.0%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Top 12 CCBs: ROE, 13.6%; ROA: 0.55%, NPLs, 6.0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>FBs</td>
<td>244</td>
<td>2% of BS assets</td>
<td>ROE, ROA, NPLs: not available</td>
<td>FBs geographic location breakdown: Shanghai (28%); Beijing (13%); Shenzhen (13%). FBs have 12.4% of total banking assets in Shanghai.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-bank Financial Institutions</td>
<td>NBFIs</td>
<td></td>
<td></td>
<td></td>
<td>The most important NBFIs are the Trust and Investment Companies (TICs), whose fortunes have been in decline since the 1998 collapse of Guangdong Intl TIC</td>
</tr>
<tr>
<td>Rural Credit Cooperatives</td>
<td>RCCs</td>
<td>30,438</td>
<td>4.4% of BS assets</td>
<td>NPLs: 14.8%</td>
<td>High degree of political interference, often managed by local cadres.</td>
</tr>
<tr>
<td>Policy Banks</td>
<td>Policy Banks</td>
<td>3</td>
<td></td>
<td></td>
<td>Established in 1994 to assume SOCBs’ policy lending role, with weak branch network, inadequate capital structure</td>
</tr>
</tbody>
</table>

Notes: 1, Assets as a percent of total domestic banking system. 2, as of YE 2004. ROA, ROE, NPLs for selected JSC banks: BoComm, Minsheng, Merchants, Huaxia, CITIC, SPDB, Industrial, SDB 

Fu and Bao recognize that relationship banking not only overcomes critical financing limitations faced by Chinese SME shut out of the equity and bond markets, but serves to lower financing charges directly through lower interest rates and indirectly through reduced collateral requirements. In their analysis of Bank of Ningbo, they argue that relationship banking must give way to transactional banking as the bank grows in size as the costs of maintaining relationships, and the difficulty of managerial control over those relationships, increase with bank size. However, I argue that the relationship banking model in China may be analytically extended to larger banking organizations through the social structures of guanxi relationships.

Zhang (2002) notes the large body of empirical evidence supporting the opacity of SMEs is the main reason they encounter severe credit rationing. Examining Berger and Udell’s (2002) discussion of different types of lending, he notes that archetypal relationship lending not only includes financial information but can encompass the vast array of information held by the company’s circle of stakeholders, including “information about corporate behavior, [firm and management] credibility, and the owner's personal conduct.”

Zhang notes the nature of relationship lending limits the number of banks with which an SME deals to a small number. He argues that this results in a significant drop in borrowing costs. However, in Chinese context, even though some transaction costs may be lower, a bank may take advantage of an SME’s fears of information disclosure to extract fees as noted above. Note also that Zhang’s expanded description of relationship banking fits well with the manner in which guanxi relationships are established and maintained.

So the SOE/private company split in banking business shows up in two ways. First, not only are private SMEs ignored by the Big Four, some may also be subjected to an even stricter segmentation to specific banks interested in making the time and effort to invest in longer-term relationships. Some parallels with Italian banking are obvious (Beck and Demirguc-Kunt, 2006, among many, find Italian SMEs encounter difficulty and additional expense in accessing financing): forced to create relationships with smaller banks, SMEs may be required to pay additional fees for access to credit. Unlike Italian SMEs, Chinese SMEs typically do not enter into multiple formal banking relationships but rather may rely on kerb market transactions to raise capital, an outcome Kellee Tsai has charmingly named “back-alley banking” (Tsai, 2002).
Larger private firms have more access to the Big Four banks, although perhaps not to the same extent which large SOE obtain.

Secondly, different lending channels for these firms lead to different requirements for credit allocation sign-offs. For the larger SOEs (and a few very large private firms), large banks’ lending policies mandate a national credit check and signoff at a senior, national-level credit committee before disbursement to the SOE (Cousin: 2007, 101-4). A local bank manager may disburse smaller amounts of credit to SOEs or to private firms. As is common banking management practice anywhere, the larger the commitment, the further up the ladder the loan must climb to be approved. [It is interesting to note that Yeung (2009) find some bankers escape “climbing the ladder” by splitting a loan into smaller pieces.]

Given the relative size of the Big Four (shown below in figures abstracted from Cousin), one might expect little chance for a personal relationship to exist between a senior banker and a senior SOE manager. But this expectation ignores four very important aspects of appointments for SOE and state-owned bank managers (these aspects abstracted from Cousin, 2007; Shih, 2008; for government appointees such as the Big Four, Bian, 1997; Huang, 1998; also Keister, 1998, for very large business groups; Nee and Opper, 2010: 2122; Shen and Lin, 2012, provide an interesting “political interference hypothesis” which suggests political appointment is endemic in developing economies’ state-owned banks):

1. Senior managers are appointed by the central government for both banks and for SOEs from a small candidate pool in which strong competition exists for the top positions in banks and SOEs;
2. Each appointee’s record is heavily scrutinized for a history of success by the government organizations responsible for the appointment and the new posting’s firm. While political interference may color an appointment and increase or decrease the probability of an appointment, it is certainly true that incompetent managers face increasing resistance to higher-level appointments;

<table>
<thead>
<tr>
<th>Comparison between Chinese Joint Stock Commercial Banks and The Big Four Banks (YE 2004)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of branches</td>
</tr>
<tr>
<td>--------------------</td>
</tr>
<tr>
<td>Average SOCB</td>
</tr>
<tr>
<td>Average JSCB</td>
</tr>
<tr>
<td>Average total</td>
</tr>
</tbody>
</table>

Source: Cousin, *Banking in China*, 2007, p. 131
3. Local governments exert influence on appointments even at a senior level, and weigh in based on their pleasure or displeasure with the prospective appointee. While this added level of veto players increases the potential for interference in an appointment, it also increases the level of scrutiny on past scandals;

4. The rotating nature of the appointments may militate against forming relationships earlier in a manager’s career, but as decades of service increase the chances of two appointees either having a relationship (bad as well as good), or knowing someone in the counterparty’s guanxi network, increase commensurately.

When a personal relationship exists between a senior banker on the credit committee, and a senior member of the borrower’s management, then relationship-embedded financial contracting should occur. This expectation arises not only through the nature of a relationship, but also because important information embedded in the relationship will naturally influence the banker in her decision. Such information may enable the banker to structure a better financial contract (or influence her to choose a worse outcome). Bankers involved in such credit decisions have access to additional data from the narrowly-defined banking relationship as well as from the wider web of guanxi relationships (Yeung, 2009; a broader contextual analysis is provided in Park and Luo, 2001; Yeung and Tung, 1996; also Keister, 2009). Hence, a question of interest arises as to how banking relationship are transformed when a relationship network is institutionalized? Then we can expect a significant amount of relationship-embedded financial contracting to occur through the entire chain of the financial industry.

Relationship-embedded financial contracting impacts both the hold-up and soft-budget problems in subtle but important ways. Organization of the Chinese banking industry makes SMEs particularly vulnerable to the hold-up problem, as discussed above and noted in the table below. This can prove to be an intractable problem: Chinese bankers often complain that SMEs are more prone to default on loans and to engage in financial legerdemain through extracting and assets and hiding losses until too late, and so are reluctant to lend; SMEs are therefore more beholden to that bank which will establish a banking relationship with them.

Governance issues with the soft-budget constraint are of greater interest in this paper, and it is here I concentrate my arguments. Here, greater access to information by regulators and private
monitor, in combination with the nature of guanxi networks in Chinese banking, can significantly improve governance outcomes. Kornai’s (1986) early examinations of the soft-budget constraint focused on the lack of a market solution to centrally-planned economies unwillingness to discipline underperforming firms through credit restriction. The problem had clear resonance in relationship banking, and so financial economists expanded Kornai’s concept into both state-owned banking (Li and Ma, 1996; Qian, 1994, sees extension of state bank lending leading to sub-optimal social welfare).

Interestingly, in the present paper both strains of economic analysis bear evidence of this problem. SOEs continue to draw support beyond what would be given in a market, hence Hsieh and Wu (2012) find a negative correlation between loan size and profitability of firm, indicating those better-connected firms- nearly always SOEs- receive excess lending. And the converse- that banks do not withhold lending- is borne out by their research as well as Bailey, Huang and Yang (2011), Yeung (2009) and others.

### Relationship Banking Challenges with Chinese Banking Characteristics

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Description</th>
<th>Chinese Enterprise Level</th>
<th>SOE/VLE</th>
<th>Solution</th>
<th>SME</th>
<th>Solution</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Hold-up problem</strong></td>
<td>Bank obtains informational monopoly in client relationship</td>
<td>Not really a problem; firm has options to go to other banks</td>
<td>Huge problem- SMEs are held hostage by banks extracting fees, higher rates</td>
<td>Encourage Big Four participation in SME lending; transparent reporting</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>soft-budget constraint</strong></td>
<td>Bank is reluctant to enforce client’s contractual obligations.</td>
<td>Huge problem - SOEs, especially, have political clout to obtain additional loans</td>
<td>Stricter lending practices; more transparency in reporting internally and externally; enhance private monitoring function of individuals and investors</td>
<td>Problem exists when banking relationship enables non-transparent dealing</td>
<td>Stricter lending practices; more transparency in reporting to regulators; encourage private monitoring by individuals</td>
<td></td>
</tr>
</tbody>
</table>
III. China’s New Information Age Model of Banking Governance

Soft-budget constraints lead to two issues in Chinese banking: the first is that SOEs are capable of obtaining loans beyond what an arms-length banker would normally extend. The second is that the Chinese banking sector suffers due to credit mispricing and, as the true value of money is distorted, not only are projects funded which may not be economically viable but self-dealing is encouraged. These issues are exacerbated due to guanxi networks embedded in a relationship banking structure. But there is a positive side to Chinese banking’s lean toward a relationship banking model. Because guanxi entails significant personal risk, in that the relationship between two parties is supportive and long-lasting, the influence of guanxi in relationship banking means that when losses occur through bad behavior there is a heightened reputational cost should that bad behavior be uncovered.

As noted earlier, guanxi as a relational institution helps both individuals and businesses in guanxi relationships to overcome resource constraints (Park and Luo, 2001; Yeung and Tung, 1996). In effect, guanxi is a kind of bridging function which enables market actors to overcome inefficiencies due to imperfect or incomplete information. But a debt is incurred when one party does something for the other (Huang, 2008; Yeung and Tung, 1996). In a sense, the guanxi relationship may lead to a quasi-contractual debt obligation, and that debt must be repaid. The “tail” created in this relational binding links both parties; subsequent discovery of ill deeds harms each party by engendering shame, or worse, for each (Li, 2009; Su, Mitchell, Sirgy, 2006; Yeung and Tung, 1996).

My argument here is deceptively simple. Because information is now so difficult to keep hidden as China has become one of the world’s more wired nations, with the most internet users; most texters; most tweeters; incredible growth in chat rooms and in servers (Yang, 2009, 2012; also see Zhou, 2011; Meng, 2011; Minter, 2013), the capacity to hide self-dealing in banking has become more difficult. The chances of disclosure have increased due to an emergent civil society (Yang, 2009) whose members are increasingly monitoring, criticizing and actively protesting bad behavior (Meng, 2009; Yang, 2012). Costs of discovery have increased just as the chances of discovery have also increased.
The Chinese government has attempted to contain the availability of on-line and other new media information through numerous means, but in each case that capacity has been compromised as web users effectively circumvent such attempts. Clayton, Murdoch and Watson (2006) showed that attempts to create a “Great Firewall of China” were easily evaded through creative addressing of information packets, and outlined how to set up a system to evade the firewall; McKinnon (2009) examined how bloggers were censored and found that much political information still made it into the blogosphere. Maintaining blogger anonymity was a key to create some space from government eyes. Beginning of 2013 brought another government to curb anonymity by requiring that a new internet user must register in his or her own name (Minter, 2013). While not affecting directly the nearly 550 million internet users presently, extensive discussions on China’s blogs illustrate this casts a near-term pall on dissent. However, this effort is likely to fail to have an effect just as other attempts to control have failed (Yang, 2009; 2012). The Chinese government can neither control the use of the internet nor close off access as the Chinese economy is now so wired into the web. Nor can the government manage the creative range of criticism which its netizens put forth, including use of code words, pictures, videos and veiled references (Meng, 2009; Yang, 2009).

These increasingly open information flows are paired with a willingness of Chinese people to stand up and criticize when they see bankers and government officials engaged in self-dealing. This criticism imparts a tremendous social and, sometimes, reputational toll as officials are fired and demoted. Recent internet outings of apparently illicit gain include pictures of officials with multiple expensive watches or in sports cars; maps of multiple apartment ownership; on-line analysis of financials behind large construction projects, and consumption of expensive wine to name just a few (Economist, 2012). Traditional media, both domestic and foreign, are joining in the fray, as Barboza’s analysis of the Wen family riches exemplifies (Barboza, 2012).

This creates a powerful social fear of being found doing wrong. And the Chinese government pays attention to citizens’ complaints- the predominant view of officials and Communist Party members is that government exists to create a strong, powerful state and that generally requires a happy citizenship. Chinese people may be a tough lot capable of enduring great hardships, but this is not a passive society as a long history has shown.
**EA Banking model for relationship banking:**

**Increased wealth**
Increase in Publically-available information
\[\rightarrow\] private monitoring

Relational
\[\rightarrow\] Chinese banking
\[\rightarrow\] is relationally-oriented
\[\rightarrow\] Value of
\[\rightarrow\] “Guanxi” has corruption & turmoil in
\[\rightarrow\] led to increased self-dealing banking & financial markets
\[\rightarrow\] corruption exposed
\[\rightarrow\] issues
\[\rightarrow\] Governance, regulations
\[\rightarrow\] [public monitoring]

Transactional
\[\rightarrow\] Better banking practices
\[\leftrightarrow\] “Price” of corruption increases due to transaction costs of those caught
\[\leftrightarrow\] [reputation loss, imprisonment, end of productive life, perhaps execution]
\[\rightarrow\] Additional information becomes available
\[\rightarrow\] [network dynamics; lower risks to discloser; capacity to secretly leak]

**Chinese relational banking should lead to better banking governance.**
Speaking truth to power is not only part of Chinese social custom, it is revered in Chinese history and celebrated today in national holidays (as an example, I direct the reader to May 5th celebrations which continue to honor the suicide of a Chinese patriot who protested corrupt government nearly 2300 years ago).

The model on the preceding page [Table 4] details the flow of my argument.

IV. Final Thoughts, and Ideas for Further Research

In conclusion, one might ask about the strength of this private monitoring mechanism I have outlined above, whether the mechanism actually will come to pass, and can it be reversed. Again, the basic idea of the argument is that Chinese banking tends to hew to the relationship banking model; this, and the nature of the Chinese economy, make the soft-budget constraint a particularly knotty problem. The soft-budget constraint, the underlying structure of state involvement in Chinese banks, the “weak side” of guanxi relationships, and a desire to get rich have coalesced into self-dealing in banking. But a new model of banking governance may be at hand, delivered through new information sources empowering private monitors to bring such self-dealing to light, a Chinese government concerned about an angry populace, and the “good side” of guanxi bringing a powerful set of disciplinary sticks. The preponderance of recent high-profile financial dealings which indicate self-dealing in China shows that, once uncovered, the stories not only have an impact on public opinion but disciplining mechanisms lock into place.

At first, this may appear a naïve argument. After all, information availability is a weak necessary condition for banking transparency. And a frequent criticism of guanxi is the claim that it is a kind of a gateway drug to corruption. But is it? Guanxi has also acted as a disciplining device throughout Chinese history, as shame accruing to a transgressor not only injures himself but also his relationship, leading in more extreme cases to ostracism from the network and, sometimes, the country or kingdom (Li, 2009; Yeung and Tung, 1996). The social value of guanxi is not to be lightly considered by anyone in a guanxi network.

This general concept of private monitoring may be extended to other countries’ banking systems; Chinese banking provides a powerful case to examine these issues, but it is not the only country in which this argument may work. Government, and banks’ difficulty in controlling information
flow will empower private monitoring and lead to greater disclosure in many countries. But this is only one of many necessary conditions. When information networks make hiding corruption more difficult, while forcing more economic transactions into the open, bank governance gains an additional mechanism through a stronger private monitoring function. This mechanism should be further strengthened where relationship banking imposes additional reputational risks through the banker-creditor personal relationship combined with the institutional relationship inherent in any banking model.

The actual impact on future banking transactions is impossible to gauge; the fact that more self-dealing seems to be made public is also difficult to discount, as the model would predict more disclosure even if self-dealing trended in a flat line or declined, due to the nature of the mechanism.

I propose to pursue future empirical papers to test this theory through examining:

- Whether the disciplining mechanisms in this model can work at an SME level;
- Instances of bank restatement of earnings, or other accounting statements, related to bank loans, initial public offerings (IPOs), and other measurable financial institutions’ activities;
- Increase in financial information disclosure through quantitative textual analysis of published news releases and web-based disclosures;
- Relationships between bankers in Big 4 and SOE managers. This would involve looking for further evidence that relationship banking may exist at a SOE level. Such a search would entail discovering
  - existence and mapping of ties
  - and an indication that credit is extended based on relationship

This paper has proposed a model of Chinese banking in which relationship banking combined with guanxi networks, increased information access and a critical, empowered citizenry improve banking governance through private monitoring. Growing private monitoring through financial institutional channels will further enhance this governance.
Bibliography


[Fu Xiaoliang and Bao Qinghua] (date) 付晓亮 & 包清华. “关系型银行贷款理论及其在我国的应用研究,” 学术研究


