Foreign Banks Enter China

China has shown sustained economic growth in the past 30 years. This impressive growth was due to the development of industries in various sectors, mainly concentrated around engineering. Further growth in the real economy requires development of the financial sector as well. The government is enhancing the financial sector in a number of ways, and most recently, foreign banks are allowed to enter China and to give loans in RMB to the local clientele. The pending opening of the Chinese banking-sector in the wake of WTO accession bears many opportunities for foreign investors. We shed light on the competitive attributes of the market and indicate crucial factors for a successful entry.

As a consequence of Deng Xiaoping’s policy, China experienced a tremendous boost in its real economy. Centers like Shanghai, Guangzhou and Shenzhen created jobs and income for a hundred million people. The focus of this industrialization is clearly engineering, assembling, manufacturing. Foreigners made investments on the grounds of the “immense market” which means, that the required return on investments was considered to be realized through earnings in the very long run. So, China had comparable cheap access to capital, paying in part by indicating the magnitude of future opportunities. In addition, China obviously had cheap access to foreign knowledge. Critics also say that production was boosted because nobody had to pay for the use of the environment. On the other hand it cannot be overlooked that Chinese engineers are skilled and creative.

Early Reforms

After Mao Zedong’s death in 1976, Deng Xiaoping (1904-1997) emerged as de facto leader of China although the formal power was in the hands of others like Jiang Zemin (*1928) and Li Peng (*1926). While keeping to the rule of Socialism, enforcing the power of the Communist Party and maintaining ideological control according to his “four principles”, Deng Xiaoping promoted fundamental economic reforms and allowed a considerable degree of liberalism. He switched to a policy of open doors, began ties with the US and other Western nations, encouraged international investment, invited foreigners to join ventures, allowed private enterprises, family farming, and many other aspects of a modern market economy.

All that was supported by a pronounced mercantilist economic policy. Low wages, promotion of exports, imposing (informal) obstacles to imports, and strong governmental investments in infrastructure. Capital flows remained strictly controlled, and the government exercised a fixed relationship between the RMB and the US$ which supported the mercantilist notion of being a “cheap” country for foreigners.

Only recently this fixed relationship is gradually modified in view of international pressure to come up with a more realistic exchange rate and authorities are also announcing that the Central Bank of China considers now a currency basket instead of the US$ alone.

Can Growth Continue?

As a result of the factors 1. Liberalization, 2. Mercantilist policy, 3. Cheap capital, know-how, and use of environmental resources, 4. Good labor input, the yearly growth of GDP had been around 10% during the last three decades. More than once western economists were forecasting a “hard landing” of China’s economy. The scenario
of a cooling overlooks the fact that we are not looking into a closed pot which can “overheat” and must therefore cool down in order not to explode. What we have observed so far is restricted to the few centers mentioned, i.e., to around 100 million people, and that a vast countryside is waiting to take over the roles from these centers. Spreading economic success over the whole country can take a century and so the mentioned centers will assume new economic roles, while leaving the task of assembling appliances with the the outback. Now the Chinese are traveling around the world, they discovered life style and fashion, and more and more we find “individual” forms of living in Shanghai. The Chinese enjoy the benefits of their hard work, foreign direct and financial help, and the favorable policies of combining liberalization with mercantilism.

The latter is more and more restricted by international pressure. In 2001, China became part of the WTO regime and is consequently forced to open the one-way street of exports. Property rights are now enforced, and foreign products are entering China to enchant local consumers. With that, foreign service firms are entering China, consultants included. The most recent chain link: The government is now granting licenses to foreign banks to open branches in China and to do business in RMB such as granting loans to the local private clientele.

Reforms In The Financial Sector
The opening of the banking sector does not come by chance. After three decades of strong growth China requires improvements of the financial system. Only functioning capital markets as well as sound and efficient banks and insurance companies can sustain the developments of the real economy. Therefore, authorities had no other choice than to look for improvements of their parochial banking system. A tremendous effort towards “capitalism” was the required cure, although the medicine was named differently.

The improvement and enrichment of financial activities was judged to be best if it happened in a gradual way, rather than in a “big bang”. In a first step, exchanges were brought into life. The Chinese population learned what securities are and got aware of the differences between bonds and stocks. Chinese are now well aware that prices of securities are volatile. They are strong savers, by the way, a result of culture and situation. According to the Global Wealth Report (Boston Consulting Group), fresh money coming from savers worldwide will grow by 5.6% per year (until 2010), while in Asia this growth is estimated to be 7.9%. So we can expect that quite a fair part of the capital required for industrial investments and for building up the infrastructure in China will come from savings of the local people. After the experience of trading among locals, shares of Chinese companies are becoming available to international investors through the Hong Kong stock exchange.

In a second step of reforms, Chinese banks were pressed to become more sound and efficient. They suffer from bad loans given to former public enterprises. At the same time, intransparent relations among various banking institutions have been disentangled. In this respect, the Chinese banking system has made big progress. Recently, a number of IPOs of Chinese banks (Bank of China, China Construction Bank, Industrial and Commercial Bank of China) underlined that they can win the “beauty contest”—to use a metaphor by John Maynard Keynes.

Having achieved this goal to prepare local banks for a further liberalization of the financial sector, authorities now (in December 2006) see China strong enough to open her banking system to foreign institutions. Under the latest reform, banks are allowed to open own branches in China in order to serve the local private and institutional clientele. HSBC is already running some 25 branches in China and is opening another ten branches. The Chinese did not allow (so far) the acquisition of local banks. A foreign institution can only own up to 20% of the equity of a Chinese bank, and the total ownership of foreign equity investors is restricted to 25%. That means that the banking system as a whole will be dominated by the Chinese. Authorities are well aware of the importance of the credit market in RMB which plays the key role in controlling the aggregate volume of entrepreneurial investments and of private investments in housing. Obviously the Chinese wish that the credit market as the instrument which transfers economic policy into a (liberalized) market setting does not become a playing field of foreign capitalism. The banking industry is not only important for credits. China’s economic success is creating a growing middle class. These people have a strong demand not only for housing (thus for loans), but also for financial products and related services to make financial investments. Well aware of the financial products available in the US, a simple “savings book” offered from a Chinese bank appears no longer to satisfy smart private investors. Private banking is a growing business in China. Here is a good opportunity for foreign banks.

Industry Structure
Even though China was able to shield herself against the Asian currency crisis of autumn 1997, the crisis lead to a heightened scrutiny of its financial system, which shares a general pattern of bank-dominated finance with her neighboring Asian countries. Far-reaching reforms of the Chinese financial sector have taken place in the past twenty-five years, however further changes are underway and still have to be implemented as demanded by the WTO accession conditions. Prior to 1978, before the nation had initiated general modernization policies, the banking sector was dominated by the monopolist People’s Bank of China (PBOC). The PBOC had central bank functions, while at the same time it supervised commercial banks that were subdivided into mere departments of the PBOC. A first step was taken in 1979 by hiving off Agricultural Bank of China (ABC) and Bank of China (BOC).
government decided in 1983 to leave only central bank functions with PBOC, with a primary focus on monetary policies. The bank was henceforth excluded from the commercial banking sector. Even though these important institutional reforms have taken place in the mid-1980ies, the Big Four were still tied to close state control. Controlling more than half of the total banking assets and loans in China, the Big Four play a vital role in China’s economic cycle. They had to - and to a certain extent still have to - provide uncompetitive state-owned enterprises with capital, which is a questionable practice producing a huge amount of non-performing loans (NPL) on balance sheets in the Chinese banking sector. For the Big Four estimates in bad loans after adjustments range from the officially published US$ 133 billion to US$ 358 billion as of 2006, a huge number which had been amounted over the past 15 years. Since the late 1990s, the problem of NPLs has been tackled by a series of bailouts and the creation of four asset management companies, in which NPLs were concentrated. After the government had passed the Commercial Banking Law in 1995, the banking landscape saw further differentiation. The Big Four were somewhat relieved of their state-lending role by three newly founded state policy banks - Agricultural Development Bank of China, China Development Bank and Export-Import Bank of China - and could further focus on providing commercial banking services. The policy banks fund themselves primarily through the issuance of bonds and have a strong role in financing state-owned enterprises. In order to enhance competition, twelve joint-stock commercial banks were founded, of which some operate on a national scale - well-known entities such as Bank of Communications and CITIC Industrial Bank - and some focus on regions, such as Shanghai Pudong Development Bank and Shenzhen Development Bank. Starting in 1995 a total of now 112 City Commercial Banks were carved out from the over 44’000 Credit Cooperatives. Both entities, City Commercial Banks and Urban/Rural Credit Cooperatives, were and to a certain extent still are part of the government’s local economic planning apparatus and therefore maintain strong government and party ties. Thus their loan extension is strongly influenced by local policy considerations. However, the government is gradually smoothing the way to a more market oriented management of City Commercial Banks by requiring that they comply with reporting standards of regular commercial banks in China. Foreign banks were allowed to set up branch institutions in the special economic zone Shenzhen in 1981. Since then, their number has increased to about 200 foreign banks that have been authorized to conduct banking business in China, 234 foreign bank representative offices and various joint ventures.

### International Competitors

Three years ago the Chinese government made a bold move and decided to turn the four wholly state-owned banks into public ones, by initializing a series of the biggest public offerings in the history of the Hong Kong and Shanghai stock exchanges. After China Construction Bank had collected US$ 9.2 billion in October 2005, Bank of China topped that number by raising US$ 9.7 billion in May 2006. The last and biggest IPO took place in October 2006, with Industrial and Commercial Bank of China’s simultaneous listing in the Hong Kong and Shanghai stock exchanges which collected a record US$ 22 billion. The fourth, Agricultural Bank of China, will by now have gained adequate insight from the experiences of its peers if it goes public in the future.

Foreign capital committed to the Chinese banking sector, in the form of either direct or portfolio investment has been considerable even before China’s WTO accession, but the capital inflow has accelerated since 2002. The total declared foreign direct investment (FDI) in Chinese banks has reached 16.8 billion US$ as of 2006, representing some 15 percent of the banking sector’s core capital. The share structure of the three publicly traded banks reveals that alert international investors have placed high strategic investments in the Big Four. In the case of ICBC a Goldman Sachs-led consortium including Allianz and American Express acquired a 10 percent stake at 3.8 billion US$ in 2005 before the going-public of ICBC. Bank of China’s capital structure includes four large institutional investors (Royal Bank of Scotland, Temasek, UBS, Asian Development Bank), which hold 16.84 percent of the bank’s equity, while China Construction Bank sold 14.1 percent of its equity capital to Bank of America and Temasek. Strikingly, these investors were willing to pay premiums for their strategic bets, even though the non-performing loans problem can be considered far from solved. The Goldman Sachs-led consortium paid 1.22 times book value for its stake in ICBC, Bank of America paid 1.15 times book value for the investment in CCB and Royal Bank of Scotland put 1.18 times book value on the line for a strategic stake in Bank of China. Since the year 2002, international competition has not only focused on China’s largest banks, but also on Commercial Banks, including selected City Banks. HSBC has been a major player as well as the private sector arm of the World Bank Group IFC. IFC obtained stakes in China Everbright Bank, Nanjing City Commercial Bank, Minsheng Bank, Bank of Beijing, and Industrial Bank, while HSBC is invested in Bank of Shanghai and Bank of Communications. Especially the strong commitment of the International Finance Corporation since the year 2001 can be interpreted as a sign of confidence in the reforms of the Chinese financial sector, as this entity is well-informed through its own research.

<table>
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<th>Receiver</th>
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<td>ICBC</td>
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links to the World Bank. The recent acquisition cases show a picture of increasing foreign stakes that in some cases even touch the 25 percent ceiling, which was imposed by the Chinese government as maximum foreign direct investment in the financial sector. A great variety of foreign institutions is involved in activities with different entrepreneurial foci. Multinational or ordinary commercial banks are placing their chips as well as specialized commercial or government institutions. One joint-venture worth to mention is the case of Sino-German Bausparkasse, funded in Tianjin in February 2004, between the Construction Bank of China and Bausparkasse Schwäbisch Hall AG of Germany. The registered capital was 150 million Yuan, with CBC holding 75.1 percent of the shares and Schwäbisch Hall holding the other 24.9 percent. Foreign banks in China used to concentrate in limited areas of business, especially trade finance and other trade-related activities in China. The reason for the restriction being, that foreign banks had to obtain a special license for doing business in the Chinese currency, Yuan, but were able to fully operate in foreign denominated currencies. The costly and time-consuming process of soliciting a Yuan-license constitutes a major barrier for foreign banks to market their services to the Chinese consumer and is supposed to fall by the end of this year, in line with the WTO accession conditions. This measure will undoubtedly amplify competition for stakes in the Chinese market, especially between foreign banks.

Strategies To Bank On
When thinking about a suitable corporate strategy with regard to the Chinese market, it is important to have a clear picture of the dynamics underlying its economic development. An important point is the income distribution across households. Today about 13 percent of the Chinese households are counted as "middle-class" with an average yearly income of 20'000 US$ per household. Analysts estimate that by the year 2010 the middle class will constitute 25 percent of the Chinese population. However, the concentration of wealth becomes evident, when considering that 0.4 percent of the Chinese households hold more than 60 percent of the country’s total personal wealth, in total of 820 billion US$. Each of these households has an average wealth of 100'000 US$, which is typically invested up to 70 percent in liquid bank deposits and to a very small fraction in equity capital. This is due to diverse restrictions hindering Chinese investors to access global capital markets and modern investment products. The situation has changed gradually in April 2006, when the government approved the Qualified Domestic Institutional Investor Program (QDIII), allowing Chinese investors to invest a certain percentage in foreign investment products. What is more, the market for mutual and pension funds as well as general asset management services is still very young and underdeveloped. Therefore the government enacted the Qualified Foreign Institutional Investor Program (QFII) in the year 2002, which allows foreign asset managers to invest in China hereby vitalizing Chinese capital markets. This will ultimately lead to the provision of better investment products to foreign and especially Chinese investors. Considering possible market entry strategies, two general entry modes have to be distinguished, which are equity and non-equity commitments. Non-equity commitments comprise all sorts of looser export/import relations and alliances on a contractual basis. An equity commitment has the advantage of ownership control, but in the case of a joint-venture implies having to solve difficult contractual agency problems, if one wants to implement genuinely new entrepreneurial ideas with Chinese partners. An alternative can be seen in the "wholly-owned approach", which implies an equity investment in order to work with the existing structures - 104 Chinese Commercial Banks with a total of 21'600 branch offices plus the approximately 44'556 strongly enrooted Credit Cooperatives. However, big players have already placed their bets and by now hold strategically important stakes in either the Big Four banks or one of the larger joint-stock Commercial Banks. The Big Four will certainly see changes in their business models, as they will have to face shareholder value oriented corporate policies after their going-public. Foreign strategic investors will have an important say in shaping future corporate strategies, while they strengthen their own strategic position. As to joint-stock commercial banks, most of them still have a predominantly state-dominated shareholder structure. However, they are allowed to engage in a variety of banking services and given their smaller size and private sector orientation, they are more agile than the Big Four and therefore have recently been the preferred joint-venture partner of international banks trying to gain access to China’s banking sector.

Others are moving fast into the Commercial City Bank sector and cherry-pick the most promising jewels, even though the NPL-problem is more severe in this sector. But through their government-steered loan policies, City Commercial Banks have not only amass ed problematic loans, but also assumed a key role in financing the SME segment of the Chinese economy, which is considered by some to be an important growth factor in China’s future economic development.
In the big picture, China is one of the largest and fastest growing markets for private and corporate banking as well as asset management services. Especially foreign banks with a focus on private wealth management do not have to cover the whole market, but should address the relatively small and easier to manage fraction of wealthy Chinese by directly addressing the clientele as soon as the market opens completely at the end of 2006.

Conclusion
The possibility for foreign banks to enter China with branches means above all that they will be able to fully effectuate business in the Chinese currency RMB and hence can tap the vast mass consumer market. This will transform the Chinese financial market to a great extent, as foreign banks will bring personnel, best practices, technology and expertise.

However, there are still great challenges to be managed, non-performing loans and a not fully reliable legal framework pose major drawbacks. The history of the Chinese economic development teaches two important lessons.

The first lesson: first movers will be able to build up almost unbeatable positions in the vast Chinese market. The car maker Volkswagen is a textbook example. Volkswagen was the first western car maker to establish joint ventures in China in the 1980ies. Market share has been at around 50 percent for almost two decades. Nowadays, Volkswagen is still the market leader, disposes of three production facilities, a qualified work force, twenty years in experience and lots of business relations - guanxi - which is an invaluable strategic advantage over competitors. Late-comers such as General Motors have dabbled at a 10 percent market share for years.

The second lesson: the Chinese are well-known for their quick learning-abilities and their long-term reliability, once a viable and mutually appreciated business relationship has been established. Establishing such relations - guanxi - takes much more than sending a fax with a price-competitive offer to the right addressee. Insofar, western enterprises have to follow a strategy that is more oriented toward long-term personal commitments. Business relationships have to be built slowly and steadily and the willingness to maintain them has to be evident. Corporate policies oriented toward short-term profit-maximization might be demanded by shareholders, but do not serve as a good lodestar for having sustained success China.

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