
# The Challenge to Tap a US$ 2 Trillion Market

# 通向 2 万亿美元金融市场之路

Foreign Banks in China.
5 years after China's entry into the WTO.

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**CBC**

This Report is based on twelve in-depth interviews, conducted during October and November 2006. Interview partners were direct observers of the Chinese financial industry, Chinese and foreign bankers, who are based in Shanghai and Beijing. Due to the sensitive nature of the information discussed, not all experts agreed to be quoted within this document. Accuracy or completeness is not guaranteed.

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# Introduction

### The Entry of China to the World Trade Organization

Over the last decades, China has become not only the motor for globalization and is nowadays the manufacturer for the whole world. This success is remarkable, given the fact that twenty eight years have past since China has opened its doors to the world in 1978. At this point China started to change its economy from a centrally planned one to a free market economy of a certain degree. This is a very short time to turn such a complex system completely inside out.

*« The entry of China into the global marketplace is potentially the largest trading route between China and the West since Marco Polo's*

In April 1948, China was one of the only 23 initiators of the GATT but it was released again in 1950. In July 1986 China applied for a renewed membership. After fifteen years of negotiations, China became the 143rd member of the World Trade Organization on the 11th of December 2001. Top Chinese leaders regard the WTO ascension to be the second most important change to China's economic policy regime, following Deng Xiaoping's reform and "opening-door" policy in the late 1970s.

The goal of the Chinese government was more targeted towards improving the local market competition, than to change the ground rules of the basic market system from communism to capitalism. The Chinese leaders recognized that China was in need of a higher level of competition in order to improve the overall efficiency of the market. This is especially true in for the heavily regulated industries such as the banking, telecommunication, energy and transportation sectors. So, the primary idea of the WTO entry was to increase overall competition with a higher level of foreign presence. Thus forcing the domestic players to improve their own quality and efficiency. The entry into the WTO was a perfect excuse for unpopular reforms among all industries. Such reforms targeted among many other points the development of infrastructure, reduction of staff, improvement of corporate governance and

# Introduction

accounting standards, encouraging a higher level of market transparency and partial privatization of the state-owned companies. The last five years have been marked by widespread economical development. However, the entry is a tight rope act for the Chinese government between reducing tariff and non-tariff barriers - and keeping in mind what change in which timeframe is really feasible for domestic market which is used to high levels of subsidizing and notorious mismanagement gone unchecked for years.

Today, foreigners have already established a strong presence in China's manufacturing sector. Furthermore, China has committed itself to a phased opening of the service sector. Starting five years after WTO entry, this commitment enables a full market access for all foreign banks to the Chinese domestic banking market. Throughout this time period, the overall improvement of the domestic banks has been pushed forward, with the target to bring the Chinese banks in line with international standards. This includes solving the problem of non-performing loans, introducing a Credit-Management framework and Management-Information-System, improvement of corporate governance and accounting standard and creating a basis for an increased efficiency in operations.

December 11, 2006 will mark the fall of the last restriction in the banking sector – RMB business with private individuals anywhere in China. On the one side are Chinese banks faced with the challenge of improving service and efficiency levels in order to be able to successfully face a strong competition made up of Chinese and foreign banks. And on the other side are foreign banks eager to enter into the one of the largest banking markets yet. But in order to enter the Chinese market, let alone reap any profits, such banks are faced with formidable obstacles. Is the playing field leveled? Are the rules of the game known? 5 years after China's entry into the WTO it is time to take a snapshot.

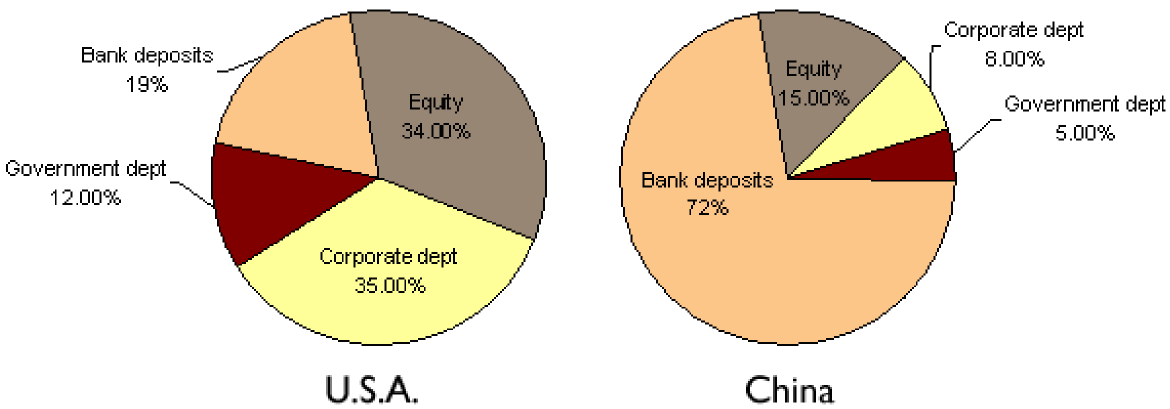
# The Market

## The Backbone of the Economy

The economic reforms and the huge population of around 1.3 billion citizens have been driving the steady economy market growth from the 1980's until now, and has created an economic powerhouse with a GDP of US$ 2.5 trillion in 2006; this at an annual growth rate of about 10%. The Middle Kingdom, as the Chinese lovingly call their own country, is predicted to become the world's second largest market within the next ten years.

The backbone of this vast economy is the commercial banking system. Therefore, China is probably the best places in the world for banks.

In 2005 95% of new funds for domestic companies came from bank loans. And these are financed through very large bank deposits. Bank deposits stood at roughly US$ 3.5 trillion – more than 150% of China's GDP. During the same period the level in the USA was 77%. Bank deposits accounted for 72% of total financial stock components in 2004 – compared with 19% in the USA.




Financial stock components of USA and China, in 2004. Source: McKinsey

It is expected that the banking industry will grow by 10% p.a. in the next ten years. During this period the retail banking sector will grow at a rate of 16% p.a.

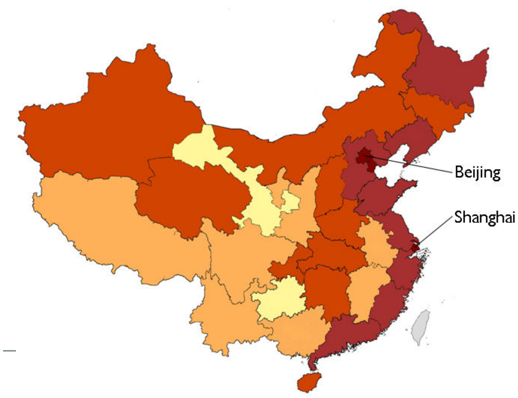
## Geographical Concentration of Wealth

A lot of western companies view China as a very promising market for commodities. Equally important is the fact, that China's population base is not directly linked to the real potential.

GDP per capita reflects the growth dynamics and wealth of the country better than a plain GDP figure. With a GDP per capita of US$ 1943 in 2006, the economy is still very small indeed.

China experiences a huge disparity across the country in terms of economic development as well market potential. For years, China has found itself in a process of urbanization. The percentage of rural residents had decreased from 79.4% to 59.5%, and the percentage of urban residents had increased from 20.6% to 40.5% from 1982 to 2003. Today are about 17.4m people living in Shanghai and 14.9m in Beijing. Overall, Chongqing remains China's biggest City with 31.7m inhabitants.

If you compare the GDP per capita per province, the picture gets much clearer, as to where wealth is concentrated. It is not surprising that the concentration is centered along the provinces and cities in the eastern seaboard. These were the regions that were allowed to conduct international business first and therefore rank at the top of the list. Shanghai had the

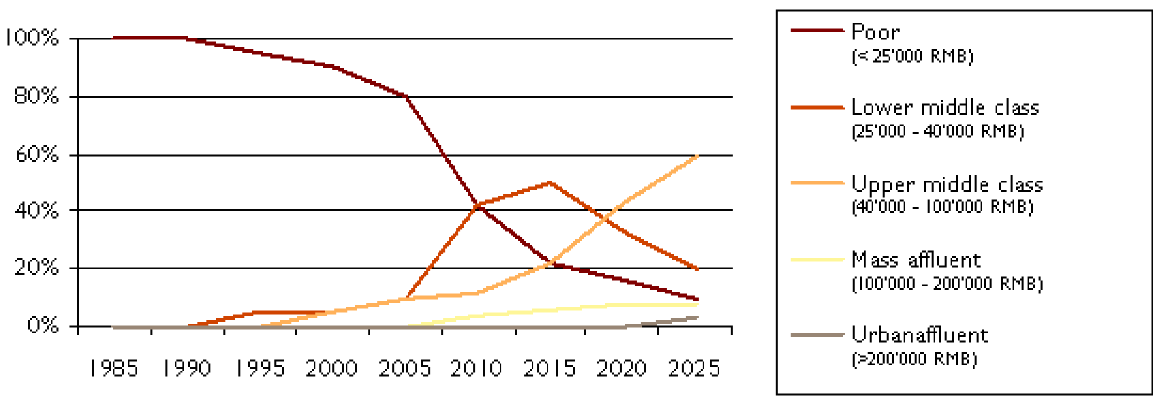


highest GDP per capita in 2004 with US$ 6'693 – 49.2% higher than Beijing. The big gap between the urban provinces and the countryside is reflected in the income levels of the residents themselves.

# The Market

Over the next years, hundreds of millions of households are going to transition from moderate poverty to middle class and just as many from middle class to upper class - with all the needs of modern banking consumers evolving with them.

One way of measuring personal wealth and consumer purchasing power is to consider the disposable income per capita. From 1990 to 2004, the national average of disposable income of countryside residents has seen an increase from RMB 686 to 2936 (US$ 355) – the income of the urban residents has increased from RMB 1510 to 9422 (US$ 1140). From 2003 to 2004 the annual growth was 11%. Among Chinese cities, Shenzhen is the richest city in terms of residents disposable income with an average income of more than RMB 24'000 (US$ 2'900). In 2004 the citizen of Shanghai earned an average income of RMB 16'682 (US$ 2'018) and the citizen of Beijing RMB 15'638 (US$ 1'892). Already at the end of 2005, 13% of the Chinese households (150 million people) had a lower middle class income of RMB 25'000 to 40'000. But still 77% live on less than RMB 25'000 (US$ 3'050) per year.




Share of urban households by income class. Source: McKinsey

According to a report from McKinsey, it is expected that the lower middle class will increase to 300 million people by 2010 and the upper middle class (annual disposable income of RMB 40'000 to 100'000) will reach 520 million people until 2025 - more than a half of the projected urban population at that point in time.

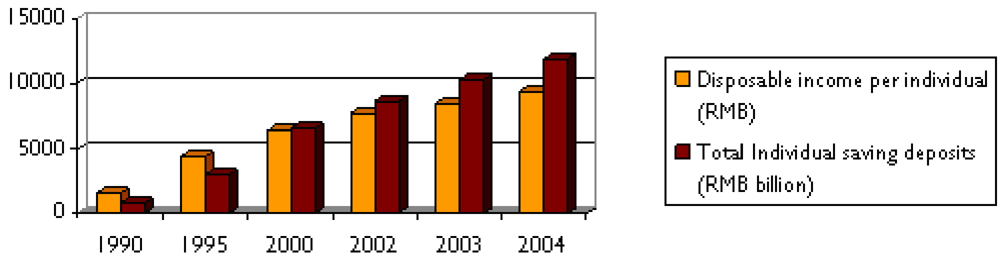
# The Market

### Raising demand for Individual Banking Services

With the rise of hundreds of millions of households to middle class, the demand for individual modern banking services will follow.

Middle-class households - the target customer base for retail banking - are still concentrated in just a few urban agglomerations, such as Beijing, Shanghai, Shenzhen, Hangzhou, Dongguan and Wenzhou. Over 95% of consumers in these cities have already a banking relationship.

Like other Asian countries, China has a very high saving rate. Private households in China save up to 20% of their disposable income in deposit accounts. This figure is close to 50% of the GDP and the highest rate in the world. Germany has a saving rate of 12% whereas the USA is at a very low 0%. Given this fact, the total saving deposit of Chinese individuals has increased significantly over the last years. Latest figures show that in November 2006 the individual saving deposits



amounted to a staggering RMB 15.8 trillion (US$ 2 trillion). Average monthly saving total is around RMB 12 billion (US$ 1.5 billion).

The management of these huge amounts is obviously a very promising market for banks which specialise in retail banking.

**Behavior of Chinese Bank Clients**

Traditionally, Chinese are very conservative and the majority still thinks of a bank only as a place for saving deposits. As seen, this is reflected by the very high saving rate. Only a small portion of any savings is devoted to investment products, life insurance or other products. This will not change in the foreseeable future. China is not only the most populated nation; it is quickly becoming the largest community of old people in the world. As a result of China's one child policy, the population is ageing faster than many industrialized countries. Therefore, the demographic development will lead to even a greater demand for a safety element. Chinese are looking for a product that protects their capital and products which can generate a steady stream of income in a potentially very strong currency. Furthermore, the Chinese banks enjoy the full guarantee of the government.

*« The saving rate will continue to be the highest globally, due to the lack of investment channels and mentality of the*

The most important parameters for Chinese individuals for choosing their bank are service-quality and physical proximity of the bank itself. Unfortunately, due to missing competition in the past, domestic banks often are still not very service-oriented. Nowadays, Chinese individuals are beginning to demand more from their domestic banks. Mainly, it is the state-owned banks that are not providing satisfying services, while commercial joint-stock banks are doing very well on their service quality. Areas that need

*« Pricing, service quality and variety of products are obviously the major criteria for the selection of their bank. »*

[redacted] overly loyal to their bank. If they would get an advice from a friend, they would change the bank. Especially because the Chinese are still quite price conscious.

The most important factor in choosing still remains the perceived proximity of the bank: number of outlets, number of ATMs, convenience of transferring money and vicinity to home or office. Chinese are yet not very active in internet banking or telephone banking. They still tend to actually to go physically to the bank. By 2010, it is expected, that than one third of all clients will embrace internet banking.

*« The service quality in Chinese banks is terrible. There is no question that this will change with foreign competitors entering the market. People will expect a better level*

Heavy regulation and fixed interest rates meant that alternatives to saving deposit were very rare for a long time. However, a significant part of the consumer group is willing to learn more about the services that are available from the Banking sector. They are especially looking for targeted and tailored individual services, such as individual wealth management, mortgage and consumer loans, credit cards, mutual funds, life insurance and pension funds. Saving through the capital market is not a big topic, but might change in the future.

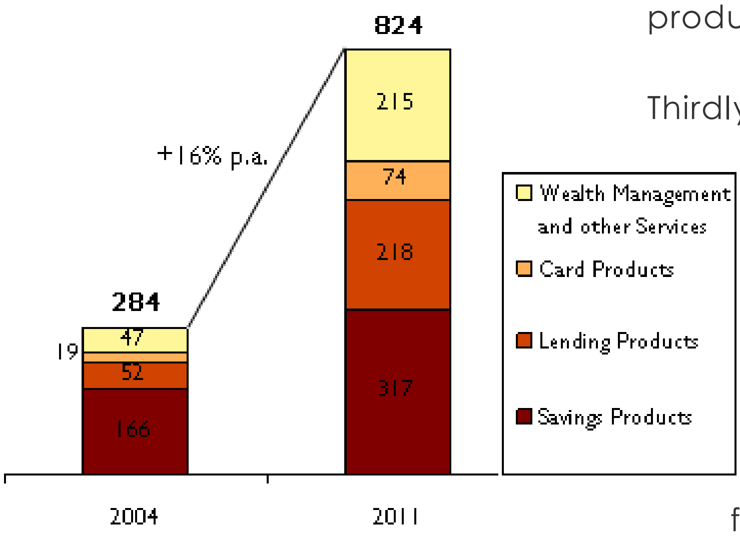
With the higher competition among Chinese and foreign banks in the retail market, brand name recognition is becoming more and more important. Chinese banks still enjoy confidence, especially due to the support from the government. But internationality appeals to Chinese people and name recognition is not equal to brand equity. You should be well known because of your services and not only of your big name. This is certainly where the Chinese banks are lagging behind.

Chinese individuals trust foreign banks in terms of the service quality, but are very sensitive toward being charged higher fees for these services. It takes time to accept foreign banks. According to a recent survey, only 16% of Chinese would change to a foreign bank and 35% wouldn't trust them at all. It might boil down to the question if the individual in question decides to be either patriotic or trust in foreign banks.

# The Market

### Drivers of the Retail Banking

Firstly, the next years will be driven by an increasing prosperity of consumers. This will boost the demand for retail-lending products such as car



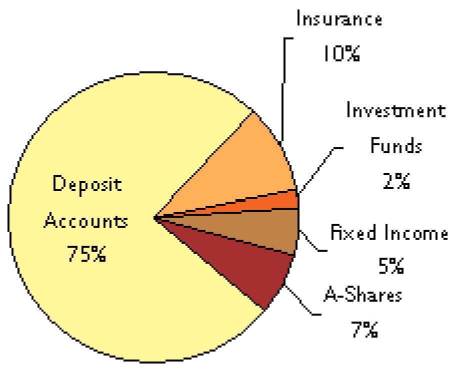

financing, credit cards and mortgages.

Secondly, it is expected that the interest rates will be liberalized over the next ten years. As a result, this will reduce the high margin on deposit and lending products in China.

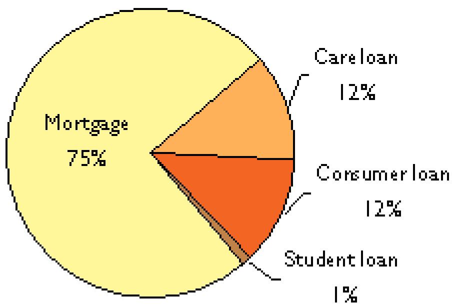
Thirdly, in the past Chinese banks have focused mainly on Corporate Banking and have seen retail banking only as a source of cheap funding. With the future development of a functioning primary capital market, corporate customers will shift towards the capital market. Chinese banks will then recognise the importance of a strong and loyal customer base in retail banking. Currently, Chinese banks are in the process of developing their service-culture, profitability and efficiency.

The consultants of Roland Berger are expecting that in the next 10 years, the banking industry will grow at a rate of 10% p.a. During this period the retail banking sector will grow at a rate of 16% p.a. from a share of 5% at present to 15% of overall net banking income. The retail banking market has reached in 2004 about RMB 284 billion (US$ 36 billion) in net banking income. It is expected that it will grow up to RMB 824 billion (US$ 105 billion) in 2011.

## Saving Products




Saving products currently remain the most important products and still account for 50% of total net banking income. This figure will decrease over next years to 40%. The main focus is still the deposit account with 75% of all invested assets of private individuals. At the end of 2006, the savings of Chinese households will amount to more than US$ 2 trillion. A lack of attractive alternative investment vehicles can be blamed for this. As long the interest rates are not liberalized, banks in China are not free to set the interest rates paid on deposit accounts and have to follow strict guidelines. This seriously limits the bank's possibilities to attract more customers, by introducing flexible products or offering higher interest rates. With the ongoing liberalization of the investment industry, especially life insurance and mutual funds, a small shift from deposit accounts into investment products is to be expected with a decrease of deposit accounts share from 75% to 65%.




Personal consumer loans.
Source: Roland Berger

## Lending Products

Lending products will be - with a current 23% growth - one of the most important products in the retail banking sector during the next years. Mortgages, with a share of 75% come in first, followed by car loans and consumer loans. This growth is driven by a sharp increase in real estate sales, new car sales and all the needs of consumers. By the end of 2004, the active consumer loans were at a total of RMB 1'980 billion (US$ 251 billion). It is expected, that consumer loans will grow with more than 45% p.a.

# The Market

### Banking Card Products

Currently the Chinese market knows three types of cards: the normal debit card, the "semi-credit" cards with a simple overdraft function and the traditional credit card with a full credit function.

Since the issuing of the country's first bank card by the Bank of China in 1986, China has become the second-largest bankcard market and has issued over 800 million debit cards, by 2005. By 2011 there will be more than 2.1 billion debit cards in China, according to expectations. Currently, 370'000 point-of-sale (POS) machines and 800'000 automatic teller machines (ATMs) are available to bank card customers across China. These numbers might be high, but still represent only 60 ATMs per one million citizens, compared to 1'300 ATMs in the USA. The availability of POS and ATM's are expected to increase dramatically over the next ten years.

With RMB 19 billion in net banking income, card products are still at a very insignificant level in retail banking. But experts expect especially credit cards to increase highly. This expectation is based especially on the fact that

consumer behaviour towards purchases paid for by cards is changing. Experts are assuming that the number of credit cards in circulation will increase from 12 million in 2005 up to 62 million in 2011. With an allowed maximum interest rate of 18.25% p.a., it is a very lucrative business field. Nevertheless, interested parties should not forget that there is no verifiable data source available anywhere in China to check and verify the credit worthiness of potential credit card customers.

# The Market

### Wealth Management Products and related Services

Domestic banks are already a major distribution channel for insurance products and mutual funds from third-party suppliers; due to the widespread branch network, the active mobile sales forces and as well to the reputation of them. A recent development is that the Chinese regulatory authority has allowed banks to set up their own fund management companies.

The new regulations issued by the CBRC now allow banks to offer beside personal financing services and investment proposals in RMB their own personal financing products. These new products mainly consist of quasi money-market funds. This is due to the lack of diversified investment tools and professional staff in domestic banks.

According to Forbes, China's rich have increased their assets by 46% to US$ 38 billion in 2006. According to Merrill Lynch, the number of millionaires (in terms


Wong
Gome
Riches

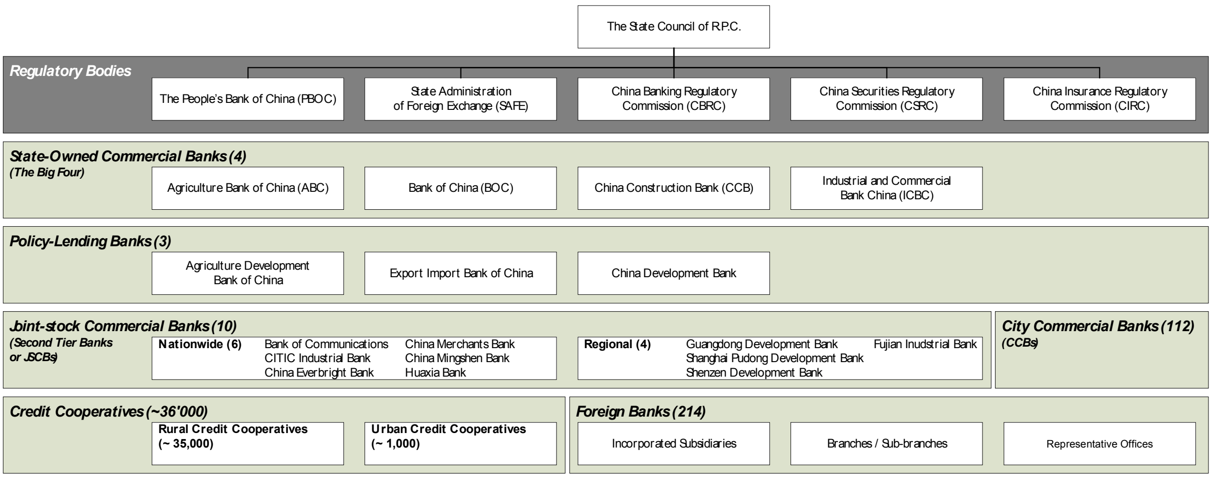
[redacted] rate of 10% every year. The wealthiest 20% individuals in China held 80% of total private wealth.

Wealth management products and private banking are major opportunities in China. Already today almost US$ 1.5 trillion in assets are under some form of management, which makes China the second largest market in private wealth management. This figure will break through the US$ 3 trillion barrier during the next four years. It is expected that the Wealth management sector will grow by 25% until 2011.

# The Environment

## Sophisticated Financial System

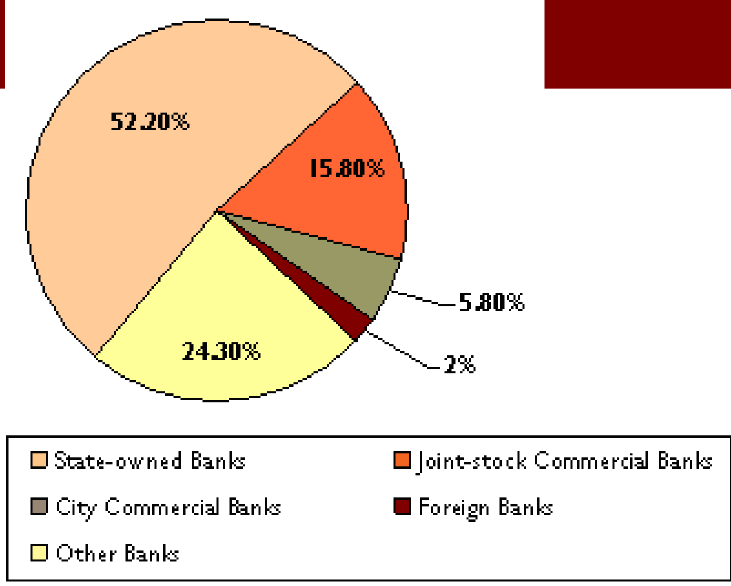
Since China's has opened its doors to the world in 1978, China's financial system has tremendous changed: from a communism typical mono-bank system in which the central government directly controlled the credit allocation through specific banks to a sophisticated system with five segregated regulatory institutions and a network of domestic banks operating on different layers.




Structure of the Chinese Financial System

The **People's Bank of China** (PBOC), acts as the central bank and is in charge of the monetary policy and the liquidity of the financial system. It sets the in interest rates for loans and deposits – as they are not fully liberalized yet. The aim is to promote economic growth, price and financial stability. The **State Administration of Foreign Exchange** (SAFE) supervises and monitors foreign currency exchange and has extensive influence over the financial system. The **China Banking and Regulatory Commission** (CBRC) is the regulatory and supervisory institution in the banking industry. It protects depositors, aims to maintain stability in the banking system, enhancing banks' competitiveness, encouraging [redacted] securities' and insurance industry.

# Domestic Market




## The Domestic Banks

There are four state-owned comercial banks, the Agricultural Bank of China, the Bank of China, the China Construction Bank, and the Industrial and Commercial Bank of China. These Banks are also known as the "big four". They accounted for 52% of the banking sector's total assets by the end of September 2006.

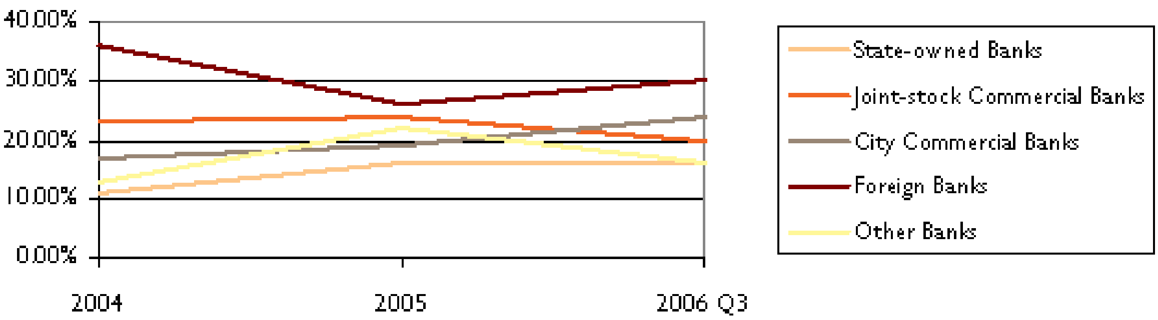
Although their market share has fallen in the last two decades, from 77% of total assets in the banking system in 1995 to 52% at the end of 2006, they are still very large. In fact, they are among the biggest banks in the world, with total assets of about US$ 2.2 trillion and an extensive branch network, with a total of about 70,000 branches and sub-branches, and over one million employees in 2004. They are the primary source of finance for large state-owned enterprises (SOEs) and other financial institutions.

The three policy lending banks, the Agricultural Development Bank, the China Development Bank, and the Export-Import Bank of China, were created to carry out the political influenced policies previously assigned to the big four.

Joint-stock commercial banks (JSBCs), have private shares, owned by government, SOEs or private entities. Currently, there are ten banks and account for 16% of total bank assets. All of them are now seeking to be listed or are already listed on the Chinese domestic stock exchanges or overseas.

# Domestic Market Participants

The biggest joint-stock commercial banks are the Bank of Communications, China Minsheng Bank, China Everbright Bank, China Merchants Bank, Shanghai Pudong Development Bank and Shenzen Development Bank. These banks are free of policy-loan constraints and provide a full range of banking services. They finance small SOEs and firms with partial private ownership, including SMEs. They maintain much smaller branch networks than state-owned commercial banks, typically confined to the region of origin or to the fast growing coastal area. Their relatively market-oriented corporate culture has allowed them to gain a very fast market share at the expense of the state-owned banks.




Annual market share growth by assets, from 2004 until 2006. Source: CRBC

The city commercial banks (CCBs) have been created by restructuring and consolidating urban credit cooperatives. There are currently 112, accounting for about 6% of total assets in 2006. They are not allowed to operate at the national or regional scale, which is their major competitive disadvantage. Finally, CCBs lend to SMEs, collective and local residents in their municipalities.

In June 2003, there were about 36'000 rural and urban credit cooperatives, which have been established to finance projects in areas where resources were scarce. They provide credit to small and medium-sized rural or urban enterprises and individuals. Their lending policies are under control of the local authorities.

Up until now, only the big four and the joint-stock commercial banks operating nationwide have had a focus primarily on the individual retail bank market.

**High-Level of Non-Performing Loans**

Domestic banks are still in the process of developing their service-culture, profitability and efficiency. This process is necessary in order to be prepared for the opening of the financial market after the WTO transitional period. In 2002, the return on average equity (ROE) of the big four banks was only 3.78%, lower than the joint-stock commercial banks with an ROE of 9.24%.

*« The really bad balance sheets are located in the small banks, such as city commercial banks or credit cooperatives. They will show up, as soon the economy slows*

By the late 1990s, the nonperforming loans (NPLs) had become a major problem of the domestic banks. They have been burdened by policy lending and the monopolistic nature has resulted in low efficiency. According to official figures, NPLs reached more than 30% of total loan balances in 2001, and private estimates put them as high as 40%. The government undertook several different initiatives to unburden the banks from these bad loans. The last steps consisted of raising capital through initial public offerings of the four largest banks (Bank of China, China Construction Bank, Industrial and Commercial Bank of China and Bank of Communication). The IPO of ICBC in October 2006, the biggest in the world so far, has raised US$21.9 billion from the stock exchange. Nevertheless, the second quarter of 2006 showed the state-owned bank stuck with staggering 10% of bad loans and the joint-stock commercial banks with 3%.

[redacted] quite high; it often doesn’t compensate the risk element in domestic lending operations. Furthermore, corporate governance and accounting standards of domestic enterprises need to be vastly improved.

**Preparing for the upcoming Competition**

The regulatory authorities have recognized that the problem cannot be solved only by huge capital injections. The system – the Chinese Banks - need to become more market-oriented. This is why the Chinese regulators have gradually updated the regulatory environment, whilst paying particular attention to the improvement of corporate governance and risk management of the Chinese banks.

*« Nothing changes over night. But the mindset of the people has changed. The banking reform is gradually improving the banking system and we will meet international standards. »*

In order to get the IPO approval, the banks had to bring their corporate governance in line with international standards. These standards included creating an independent board of directors and a board of supervisors, adopting better credit risk-management systems based on economic capital restriction and internal controls, and completing the transition from a politically influenced to a market-oriented decision making.

*« Since the IPO, our management became more transparent and more alike to the style of Western banks.*

Inviting strategic investors into Chinese banks has been crucial to the advancement of good corporate governance. Currently, foreign banks are not only investing strategically, but are contributing in-depth knowledge regarding mana-gement models, corporate governance and risk management. “Inviting [redacted] vertical management models to establish independent credit officer and risk approver structures. They introduced risk rating tools, loan pricing management and are also focusing on teaching their staff basic banking skills in order to set up a better risk awareness culture.

# Domestic Market Participants

However, some observers say that the Chinese banks still are lagging far behind in terms of operational systems and risk controls. Given this assessment, the overall quality of China's banks can be described as poor and uncompetitive.

The branch networks of the Chinese banks are very large and widespread. It is widely recognized, that it is a major challenge to manage such a widespread network without unified IT-systems. Despite the fact that most of the commercial banks have already implemented or are in the process of implementing a core banking system, it will take years to unify all the proprietary systems employed by the various outlets. Even nowadays many central processes are paper based. A further central issue is that the financial industry definitely lacks local financial talents. ICBC alone has more than 20'000 branches. Every single one of them needs a risk manager. And the training of a good risk manager requires at least five years.

*« Many branches have their own IT-systems, which are not compliant with the head office. They report manually, with all the human mistakes. »*

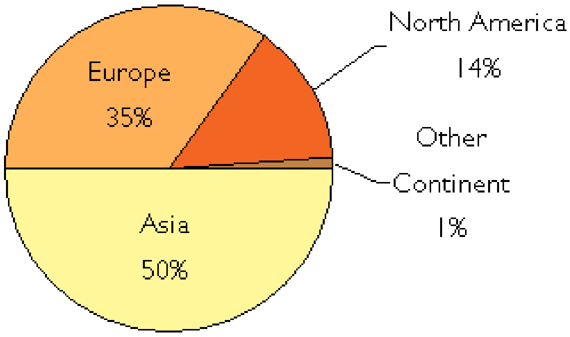
[redacted] employees. On the other hand, their very proximity to their huge customer base is probably the biggest advantage of the Chinese banks compared to the foreign banks entering the market.

The consolidation process does not stop on an enterprise level. Chinese and foreign bankers definitely see an upcoming consolidation phase among smaller domestic banks. As a result, Chinese banks fear less the direct competition with other foreign banks as they fear the competition among the domestic banks.

Overall, the impressive efforts already undertaken by Chinese banks will enhance certainly their competitiveness.

# Foreign Market Participants

Origin of foreign banks by continent in 2004. Source: CBRC




**Foreign Banks in China**

Since the entry of China into the WTO in 2001, China has very much moved into the focus of foreign banks. Their number has increased by 28% in the last five years. September 2006, marked the presence of 183 foreign banks from 41 countries with 242 representative offices. 73 foreign banks from 22 countries have set up 252 operational entities (191 branches and 61 sub-branches) in 24 cities in mainland China. Almost all the big players are present, mainly from Asia and Europe. They are concentrated mainly along the East coast of China and a few other important business regions, due to the regulation so fare but also of the geographical concentration of attractive customers. By end of 2005 in Shanghai alone foreign banks have opened 68 branches and 95 representative offices (more than 30% of all foreign banking institutions in China).

Over the last five years, foreign banks have more than doubled their profit in China. In 2005 they earned a combined $US 446 million – in 2001 it was US$ 196 million. Most of them are concentrating on trade finance, money market operations and foreign ex¬change. The most profitable areas appear to be trade finance and treasury operations, while Corporate Banking is only marginally profitable and retail banking is yet not profitable according to a

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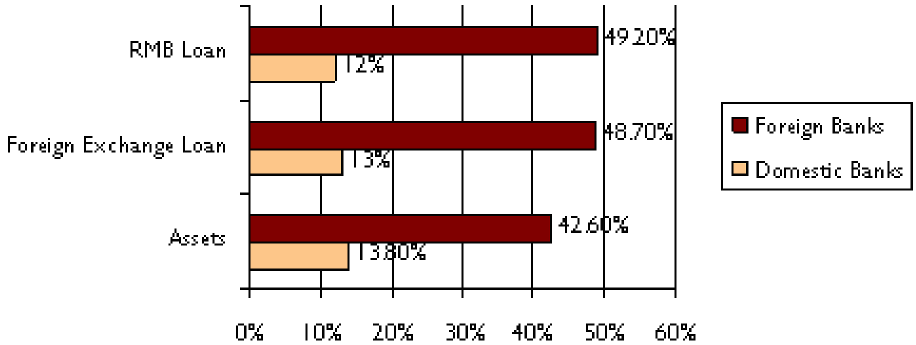
recent survey of PriceWaterhouseCoopers.

# Foreign Market Participants

Until today, foreign banks still play a very limited role in the Chinese banking system. By the end of September 2006, the total assets of foreign banks in China, both in RMB and foreign currencies exceeded US$105 billion. This accounts only for 1.9% of total assets of all banks in China. So far, they cannot exercise a big influence on the Chinese banking market. But foreign banks are growing at a much higher rate than Chinese banks - 42.6% consolidated annual growth rate in assets over the last five years, compared to the domestic banks with 13.8%. Even if their relative size is negligible, foreign banks already account for 20% of foreign exchange loans, but only for 0.5% of loans in RMB.




Annual Growth Rate of Foreign and Domestic Banks. Source: Xiaoju Zhao (2006).

## Gradual Opening up of the Market

With the entry of China into the WTO, a plan was set up to help the industry, the infrastructure, the social system and the agriculture systems to be ready for an open economy within five years. However, most attention was paid to the banking industry, due to their important position in the economy.

[redacted] regarding customer types which can be served and banking products as such.

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Foreign banks initially were restricted to foreign currency business. These obstacles have been gradually relaxed, allowing the foreign banks to expand into local currency services for domestic corporations by 2002. By 2005 RMB business for foreign banks has been gradually extended to 25 cities, which made business more interesting for foreign banks. The 25 cities in question were Beijing, Changchun, Chengdu, Chongqing, Fuzhou, Dalian, Guangzhou, Harbin, Jinan, Kunming, Lanzhou, Nanjing, Nanning, Ningbo, Qindao, Shanghai, Shengyang, Shenzhen, Tianjin, Wuhan, Xian, Xiamen, Yinchuan and Zhuhai.

China also committed itself to gradually open the securities market, which so far is split up in A-shares, reserved for domestic investors, and B-shares. Foreign investors have been allowed to access the B-share market and joint ventures have been allowed to raise funds in the A-share market. Furthermore, a qualified foreign institutional investors (QFII) scheme has been introduced. This scheme allows foreign institutional investors to engage in the closed A-share market. The minimum operational capital required for foreign banks has been lowered and the maximal shareholding percentage for foreign banks in domestic banks has been increased. A single foreign bank can hold a maximum of 20%, and multiple foreign banks can hold up to 25% shares of one specific Chinese bank. Above that, foreign banks are allowed to acquire interests of up to 49% in fund management enterprises and up to 33% in joint venture securities firms involved in underwriting domestic and international debt and equity issuing.

Foreign banks consequently opened up their business scope step by step. By 2005, already 138 foreign banks were allowed to engage in RMB business; 73 of which can provide RMB service to Chinese enterprises, in 25 Cities. 49 financial institutions have a QFII status. 41 are engaged in derivative business and 15 foreign banks are allowed to offer e-banking services. Foreign banks can today already provide more than 100 products within 12 basic business types.

# Foreign Market Participants

### Strategies to Increase Market Share

Over the past five years, several strategies to enter the Chinese market and to increase the market shares have arisen among foreign banks.

#### 1) The Strategic Investment Approach

Over the last five years China has started to invite foreign banks to join China's commercial banks by equity participation, in order to enhance their competitiveness by improving their risk management and financial product innovation. More than twenty Chinese commercial banks, including three of the big four State-owned banks, have attracted a total of 25 foreign financial institutions.

In March 2006, foreign banks spent a total of US$ 17.3 billion on Chinese bank shares. Direct foreign investment in the financial sector was around US$14 billion last year, which is more than 16% of overall FDI in China. In 2004, it was less than US$2 billion. It is expected, that this figure will increase in the next year as the sector opens up further. However, foreign banks are currently still limited to a combined maximum investment into 25%

*« I don't see the government allow a foreign bank to control a*

[redacted] around Citigroup, with foreign and domestic enterprises, has recently acquired the majority of Guangdong Development Bank. Citigroup still held only 20% in this consortium.

A strategic partnership immediately opens the door to domestic customers. However, the foreign bank will always remain in a minority position. Some foreign bankers doubt that foreign banks will be able to get any strategic value from their investments. They will need to rely on the corporate governance of the domestic banks. In any case, there will be the profits from the increasing share prices.

**2) Global Bank Approach with Organic Growth**

Among other major players, HSBC, Citibank and Standard Chartered have taken an aggressive approach to offer a complete range of banking products everywhere in China: from saving deposits to sophisticated investment products for individual and corporate customers. They have been rolling out new branches as quickly as they were allowed and moved into new product markets as soon as regulations permitted them to do so. These banks are planning to incorporate in China as soon as possible. Given the relatively high geographic concentration of attractive customer groups in urban regions, nationwide presence is not necessary for them. This allows them to focus on an overall market penetration strategy. The advantage of an organic approach relies on the fact, that the bank does not require a partnership and controls its own business. However, it requires significant capital investment and sufficient time to set up a branch network. The mentioned banks are able to take such an aggressive approach because of their size and overall profitability. They employ all their resources available to them.

**3) Approach of Wholesale Banking for Corporate Customers**

The majority of foreign banks are involved in "me too"-prodcuts for international enterprises, such as lending in foreign and local currency, cash management and so on. Mostly they rely on their captive client bases, who are engaged with China. Bottemline, they all are fighting for the same customers. Some bankers have expressed the feeling, that

*« There are just not enough international corporates in China to make all of us happy. »*

[redacted] banks can make easy profits. However, as soon the interest rates will be made flexible, the credit market will be a money-losing market. Operations for foreign banks will become even more challenging.

**4) Approach of Innovative Products**

Some banks have chosen a niche strategy. They pick a certain segment of the market and offer innovative products such as structured financing, investment banking, securities, etc. These sophisticated financial products are often not easy to copy, due to the lack of knowledge and sufficiently trained staff. The regulations allow them to build these niches and offer Chinese customers new and exiting products.

**5) Dual Approach**

Most banks are trying to combine organic growth on their own and joint-venture business with strategic investment partners. According to Dr. Horst Löchel, chairman of Shanghai International Banking and Finance Institute, a dual approach with organic growth and strategic partnership currently seems to be the most attractive strategy for foreign banks to increase their market share. It promises the highest benefits combined with a lower risk level compared with an strategic partnership.

In an environment like the one in China, where the rules of the game very often change, it is essential to have multiple options. This is even more true than in most other countries.

**The Challenge for Foreign Banks aiming tap the Market**

On the November 9, 2006, the state council published the new regulations for foreign banks wanting to do business in the Chinese banking market. December 11, 2006, China will remove all geographic restrictions for foreign banks and allow them to offer full local currency banking services to domestic individuals as well as corporations, in order to fulfil the formal obligations of WTO.

*« We have fully complied with the promises of making a complete market opening. » Song Dahan, deputy director*

Superficially, it looks like the market is fully liberalized. But, it is still far away from being a level playing field for all market participants. The new regulations, even they apply to foreign and domestic banks alike, deeply impact foreigners' operations and practically slow down their expansion in China. The rules are even more restrictive with regards to letting new banks into the market. Some western bankers have voiced concerns, that the rules have been specifically worded in order to protect Chinese banks from a direct head-to-head competition.

For the time being, the system of different banking licenses will remain as it is. Firstly, a foreign bank can establish a representative office to serve their overseas customer base. New is, that the bank in question needs to put an effective anti-money laundering mechanism in place and is required to report it

*« The regulatory authority searched for other ways to protect their domestic banks and invented bizarre regulations which hurt the foreigners, and not*

[redacted] be restricted by CBRC. Foreign banks will only be allowed to have one representative office in China. The next stage is to upgrade towards a branch based system. This is the only way it can conduct business in foreign currency with local corporations. Beside branches no other representative offices are allowed anymore. If the foreign bank wants to get a RMB-license, it must have operated in China for three years and been profitable for two consecutive years, which is all but easy for newly opened branches. On average, it takes a branch about three years to become profitable. It has then to decide if it wants to either get incorporated in China or if it wants to continue to operate through a branch of the head office overseas.

A branch office remains under the direct control of the headquarters and as such is supervised by banking regulators in its respective home country. To set up a branch, the foreign bank must have more than US$ 20 billion in total assets at the end of the previous year and needs to capitalize every branch with RMB 200 million ($US 25.4 million). However, the branch is still banned from engaging in RMB-business with Chinese citizens, unless a Chinese individual has obtained the approval of the banking regulatory authority and makes a fixed deposit of at least RMB 1 million (US$ 127'000). This seriously limits foreign banks in reaching the mass market. It forces them to focus on the niche market of high net worth individuals or corporate customers. And due to this limitation of only being able to handle large deposits, it is limiting the foreign banks amassing funds in local currency and grow through lending. Furthermore, the branch will also not be able to issue bank cards.

To offer banking services to the general public, foreign banks need to incorporate on the mainland. They must have more than US$ 10 billion in total assets at the end of the previous year and need to register a capital of minimum RMB 1 billion (US$ 127 million). "That is 20 times more than what in Europe the norm is", says a foreign Banker. Only a few banks will be able to do so and even less will be interested to do just that. The subsidiary registered in China

*« If you are into retail banking, if you are into personal financial services, asset management, you have to become locally*

will be a corporate entity under Chinese law and as such is supervised by Chinese banking authorities. Beyond that, every branch must have separate RMB licence and a minimum operating capital of RMB 100 million (US$ 12.7 million). The incorporated subsidiaries will be allowed to conduct foreign currency and RMB-denominated businesses with corporations and individuals, including taking individual RMB deposits, granting short-term and long-term loans, offering mortgages, offering foreign-exchange, buying government bills and bonds, offering banking cards including credit cards, as well as selling various insurance products to the public.

*« Multinationals need large RMB amounts, and that is exactly what the foreign banks should be prevented for being to provide. This regulation makes sure that this is the case. Chinese call*

The new regulation defines the ratio between outstanding assets and outstanding liabilities, which should be not less than 25%, which means that the overall lending must be kept below 75%. A branch can lend with a capitalization of RMB100 million a loan volume of maximum RMB 75 million (US$ 9.5 million). This is not a particularly high volume. A big multi-national corporation who is operating in China needs 100 times this amount. Foreign banks specialized in corporate lending will – given the small volume - have no effect on the market. The government don't want to see competition in corporate lending based on local currency.

Due to the unlimited guarantee from the head-quarters of the foreign banks for all their liabilities around the world, they would not need to capitalize their branches to such a high extent. Unfortunately, CBRC [redacted] venture banks between foreign and domestic banks. This is very unfavourable for most of the foreign banks because the domestic banks have their head offices already incorporated in China.

Capitalization of branches is - especially for smaller foreign banks - a huge burden on available equity, thus slowing down their expansion. Achieving a ROI under such circumstances is very difficult. Furthermore, due to the capitalization of every branch, no real treasury consolidation is possible among the branch network. The new requirements could even push some smaller foreign lenders out of the Chinese Market.

*« The impact of the new rules on the foreign banks depends on their size. The larger ones are already at a size where no large additions to operational costs are to be expected in terms of*

If foreign banks wish to increase their capital, which is a prerequisite to increase their RMB business, the regulatory authorities require an approval. First of all, this process is very slow or even could get rejected due to special reasons i.e. to protect the domestic market. Above this, SAFE's regulations for foreign exchange are even tighter than three years ago. Exchanging foreign currency to local currency is theoretically allowed, but the obstacles present today render this virtually impossible. Tight RMB policies are in place in order to prevent currency speculation. The Asian financial crisis from 1997 still is very much present with Chinese authorities. During the Asian crisis it became clear how vulnerable countries with relatively small foreign reserves are.

"The set quotas on how much the foreign banks are allowed to re-finance from outside the country seemed to be set very tight. A lot of the smaller

[redacted]

Some foreign bankers voice the opinion, that they are gaining the impression, that foreign currency investment is not welcome anymore in China. This seems true in some way. Chinese Banks possess by far more liquidity than foreign banks. Foreign reserves stood in November 2006 at US$ 1 trillion and bank deposits at US$ 3.5 trillion.

The only possible ways for foreign banks to refinance in RMB is actually either getting deposits from corporate customers or get the money through the inter-bank market. Increase assets through the inter-bank market is very expensive, currently at about 2.9% of funding costs. By taking deposits from their huge customer base, Chinese banks currently get their money at about 2%. Due to the fixed interest rates by the central bank, banks have a considerable margin between the cap on deposit rates and the floor for lending rates. Domestic banks can leverage this strong advantage with their lower funding costs.

> *« The loan prices from foreign banks are higher and usually based on correct risk calculation for the pricing. Chinese banks sometimes don't do*

In order to compete with the domestic banks and get cheaper refinancing in local currency, foreign banks need to get access to the very attractive retail banking sector to build up a high customer base. This is not easily achieved, even for banks that have chosen a global bank approach. As long as the physical proximity of the branch is very important to the Chinese retail customer, a foreign bank is required to set up a relatively large branch network in China. And this process is excruciatingly slow, as the foreign banks need the approval from the regulatory body on a city by city basis. This approval process takes at least six months and after receiving the permission, the foreign bank needs to open the branch within six months. Furthermore, it costs vast amounts of money to reach the capital requirements for every branch.

[redacted] wish to increase their number of branches, whilst almost all Chinese banks want to decrease their number of branches. For them, current restrictions have no major influence and limits foreign bank's growth. Arthur Kröber, editor of China Economic Quarterly, predicts that it is unlikely for foreign banks to get more than one branch approved per year. "You easily could spend 20 years building up a 20-branch network." That means by definition, that foreign banks will not be able to get a lot of deposits in a short timeframe.

But not only the increasing number of new regulations is making business hard for foreign banks. Western people are used to a set of regulations without a big room for interpretation. In China this is very different: Foreign banks often miss legal certainty. This uncertainty comes from the fact that the Chinese government adopts the principle of rule by law rather than the rule of law. The interpretation of a set of regulations is completely up to the authorities, which can vary by region.

*« You only have certainty if you have the rule of law and not the rule by law. »*

Should the foreign banks wishing to do business in China, they have to overcome all the abovementioned obstacles. But also human resources remain as a very critical aspect. Chinese resources trained in management are scarce. “The demand in the banking sector for professionals is so strong, that supply just cannot keep up”, says Prof. Dr. Horst Löchel, chairman of the Shanghai International Banking and Finance Institute.

# The Competition

**The Fear of a Level Playing Field**

Financial experts say that despite of huge capital injections and a government-driven reform which has culminated in huge initial public offerings; Chinese banks still need to close a ten year gap in areas such as risk management and credit assessment, which has in the past resulted in a high percentage of non-performing loans. The situation is for CRBC very difficult. Even with the huge liquidity of the domestic banks and their lobbying to protect the domestic market, authorities are very much aware of the fact that they require the know how of the western banks in order to improve the overall service and product quality of Chinese banks. On the other hand however, the regulatory bodies fear that if they would let the foreign banks enter the market in an un-restricted fashion, those banks would immediately gain a significant market share. Low-risk clients with would quickly migrate from Chinese banks to foreign banks. Most bad risks would then remain with the Chinese banks. The large state-owned banks would face huge problems, possibly go bankrupt and potentially collapse the financial system. There is no doubt that a full opening of the market would be extremely painful for the Chinese financial system. At the same time, this process is critical for China's next stage of development, which certainly will be based on investment.

*« The entry of foreign financial firms into China will bring huge risks to the country's financial market » Zheng Xinli, Deputy*

The government certainly wants to remain in control of the speed with which the banking system is opening itself towards the outside world.

"The complete opening of the Chinese financial industry is taking place gradually, according to schedule. This strategy must be strictly maintained, and should not be influenced by external factors", said the financial expert Yi Xianrong of the Chinese academy for social science.

A statement released by the government explains, that the purpose of the laws was to open the market, strengthen supervision of foreign banks and encourage the development of local banks and finally to protect the interest of domestic depositors. Some Chinese bankers argue that the new regulations on foreign banks are designed to ensure a smooth transition, to give the domestic banks time to catch up with the foreign banks. They are also in-line with global WTO practice and are non-discriminatory, because they apply to Chinese as well as foreign banks. Rules requiring foreign banks to incorporate locally are not unusual in other Asian countries such as Australia, Malaysia, Indonesia and Singapore.

Ba Shu Song, a senior official at the Development Research Centre of the State Council, said: "The rules establish a platform for fair competition between Chinese and foreign banks. Since it is more costly to set up a corporate entity in China, the regulation will help to protect the domestic banks."

It appears that the non tariff barriers erected through bureaucratic hurdles, the discretionary application of rules and regulations and the high funding requirements are designed to soften the impact of foreign competition on inefficient and often largely insolvent local banks. This might mark China's latest effort to enhance the ability of domestic banks to compete with overseas rivals.

Some Chinese and foreign banker argue that China has also the right to claim a level playing field for their banks. So far, only the Bank of China has been able to open a branch overseas. And as long the Bank [redacted] concerns of the government and their actions to gradually improve the conditions for all market players to ensure a truly level playing field for all parties involved.

# Conclusions

## Conclusions

There is no doubt, that the Chinese banking market is not yet a level playing field, neither for the foreign banks from overseas, nor for the Chinese banks.

*« The challenges of foreign banks to seize the opportunities in China are to understand China and to respond in time. »*

Foreign banks who are willing to tap the promising retail market of US$ 2 trillion, will be facing big challenges. Bureaucratic hurdles, discretionary application of the regulations and immense high capital requirements aside, there is also a need to understand the local market. This enables the development of financial products, which are in-line with the demand from Chinese customers. On the other hand, they can profit from their strength in developing sophisticated products, due to their highly-skilled staff and global expertise and evolved management culture, which is characterized by flexibility, decision-speed and sophisticated internal controls. Theoretically, they immediately could take advantage of Chinese' lower level of experience and cash-in on China's burgeoning economy.

Market rumours have it that about ten to fifteen foreign banks are interested in tapping the US$ 2 trillion Chinese retail banking market. It is expected that Citibank, HSBC, Standard Chartered, Hang Seng Bank, Bank of East Asia and ABN Amro will be among the first group to get their businesses incorporated in China. From the German-speaking countries only Deutsche Bank has openly published plans to enter the Chinese market.

In general, foreign bankers expect foreign influence on banking to grow only slowly, with many of the world's biggest lenders choosing to tap the market mainly by minority stakes in Chinese banks.

# The Competition

It is easily forgotten, that it is only twenty eight years ago, that China has opened its doors to the world in 1978. This year marked the start of a slow and steady move of its economy from a centrally planned to a special – Chinese - flavour of free market economy. The improvements in the last twenty years are truly remarkable, especially if compared with other countries that were running under a cent-rally planned system. It is clear that  China is not yet anywhere near the position, western countries currently hold. However, the fashion with which the Chinese government rules the economy needs to be highlighted. Compared with other developing countries, China is in much better shape than most others. The Chinese government listens very carefully to their think thanks. From an objective point of view, China currently is doing the right thing for the domestic economy.

*« It will take at least a decade, before this market really opens up and will be a level playing field for international banks and*


Chinese and foreign Banks, Source:

One fact remains, however: December 11, 2006 is a historic step towards the gradual opening of the country's financial industry. But it remains the starting point, not the end point of the reform of the banking market. And it will definitely be more evolutionary than revolutionary, unlike some people have expected in 2001.

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