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Can Foreign Entry Transform China's Banking System?

By Nicholas Hope and Fred Hu

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China's accession to the World Trade Organization (WTO) in December 2001 was highlighted by the promise to throw open the formerly tightly closed domestic markets for services. Some of China's most far-reaching commitments to introduce foreign competition involved the banking system, where foreign banks were guaranteed phased access to the Chinese market with the elimination of all restrictions on their business activities within five years (i.e., by December 2006).

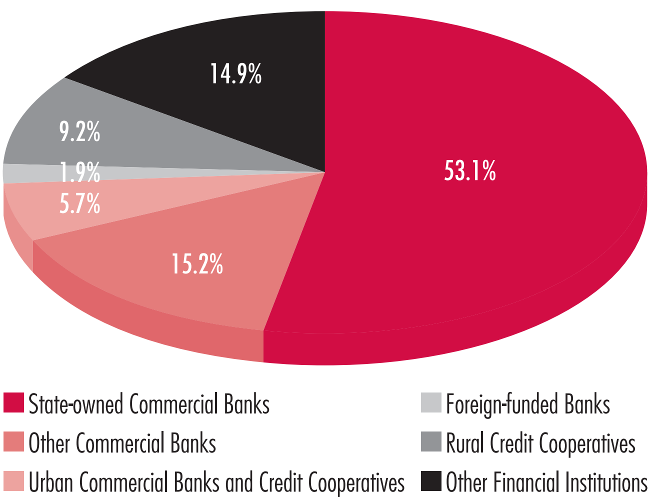
The East Asian crises in 1997-98 had heightened the Chinese Government's concerns about the vulnerability of China's banking system, and the prospects of foreign competition following WTO accession added urgency to banking reforms. Since 1998, the Government has moved aggressively to strip bad loans from the major state-owned commercial banks (SCBs) and consolidate them in asset management companies. It has also injected massive amounts of new capital into three of the SCBs, most recently by redeploying US$60 billion of China's abundant foreign exchange reserves through the vehicle company, Central Huijin Investment Limited.

But with the WTO deadline now barely a year away, China's domestic banks are unlikely to have restructured sufficiently by then to face vigorous foreign competition on even terms. The Chinese Government might be tempted to delay foreign entry and give its banks more time to prepare, but that would have the undesirable consequence of delaying further the development of an efficient banking sector.

Why China Wants Investors in Domestic Banks

The deficiencies of the Chinese banking system generally have arisen from two main sources: Government policies and the lack of expertise within the domestic financial institutions. Efforts to improve policies are ongoing; and foreign entry promises considerable improvement over time in the quality of Chinese banking services. But with foreign banks' share of banking assets still tiny (less than 2 percent — Chart 1), improved service from the banking system as a whole clearly requires much better performance from China's domestic banks. The expertise of strategic foreign partners has the potential rapidly to improve their performance in virtually every dimension.

Chart 1.
Assets Distribution of Financial Institutions
End 2005 H1
Total Assets: 35.08 Rmb Tr.



Recently, foreign investors have shown considerable interest in three of the four major SCBs, as well as many of China's smaller banks (see Table 1). But many uncertainties about how foreigners might participate in Chinese banks remain. The interests of foreign investors, the broad spectrum of domestic banks, and the Chinese Government — including the regulators — might not coincide; the likelihood is for the partnerships to be initially uneasy ones that might take some years to deliver hoped for results.

What's In It for the Foreign Investor?

The commercial attractions of the fast-growing Chinese economy are obvious (Chart 2), but why choose to enter China by investing in a Chinese bank when one can go it alone? The recent acceleration of consumer lending illustrates the vast opportunities now emerging in the Chinese market, and foreign banking interests clearly might regard immediate access to well-developed distribution networks as suitable compensation for operational deficiencies in their Chinese partners.

Potential foreign investors in the Chinese financial sector can draw other positive signals from the Government's commitment to continuing financial reforms. Considerable relaxation of controls on interest rates and of regulation of fees points toward full liberalization over time, and opportunities for profit also lie in using domestic banks' extensive distribution channels to introduce business models offering integrated financial services. There is the prospect, too, of a substantial financial upside for foreign investors who help to engineer an effective turnaround in the profitability of their partner banks.

What Are the Main Concerns?

To balance the attractions of China's financial sector, the prospective foreign strategic partners have to contend with some less-appealing factors. Several issues should dominate investors' deliberations:

Corporate Governance: The governance structures of Chinese banks are not conducive to an effective system of checks and balances; there is a dearth of independent directors and effective board committees. The banks have yet to develop a culture of full disclosure; the

Table 1. Strategic Investments in Chinese Banks: 2004-05

Bank	Strategic Investor(s)	Date Completed	Deal Size (US$ million)	Investment as % of Company
Nanchong City Commercial Bank	German Investment and Development Bank	Pending	4.8	13
China Everbright Bank	Standard Chartered	Pending	NA	NA
Industrial and Commercial Bank of China	GS, Allianz, and American Express	MOU signed in Aug 2005	3,700 (est.)	10
Bank of China	Royal Bank of Scotland and co-investors	Aug 2005	3,100	10
	Temasek	Aug 2005	3,100	10
China Construction Bank*	Bank of America	June 2005	2,500	9.0
	Temasek	July 2005	1,400	5.1
Bo Hai Bank	Standard Chartered	Sept 2005	123	19.9
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	April 2005	76	19.9
Bank of Beijing	ING	March 2005	215	19.9
Ji'nan City Commercial Bank	Commonwealth Bank of Australia	Dec 2004	17	11
Xi'an City Commercial Bank	Bank of Nova Scotia	Nov 2004	7	5
	IFC		19.9	12.5
Minsheng Bank	Temasek	Oct 2004	106	4.55
	IFC		23.5	1.2
	Hang Seng Bank		NA	8
Bank of Communications**	HSBC	Aug 2004	1,747	19.9
Shenzhen Development Bank	Newbridge Capital	May 2004	149	17.9

Source: Nicholas Hope and Fred Hu, "Reforming Chinese Banking: How Much Can Foreign Entry Help?" SCID Working Paper, *forthcoming*.

*The China Construction Bank raised US$8 billion in a successful initial public offering in Hong Kong in the last week of October 2005.

**The Bank of Communications raised US$1.9 billion in its offering in June 2005.

information now released falls well short of international standards for best practice. Although foreign partners might do much to remedy matters, whether they will be allowed and encouraged to do so remains in question.

Control and Management: Influence on overall governance depends on the extent to which the foreign partners can exercise control over important aspects of the invested banks' activities. Foreign ownership in domestic banks is restricted to 25 percent, with any single foreign investor limited to less than 20 percent. Chinese managers might cede considerably more of their authority to foreign partners than share ownership alone would warrant; but they also might endeavor to minimize the extent to which they share decision-making power.

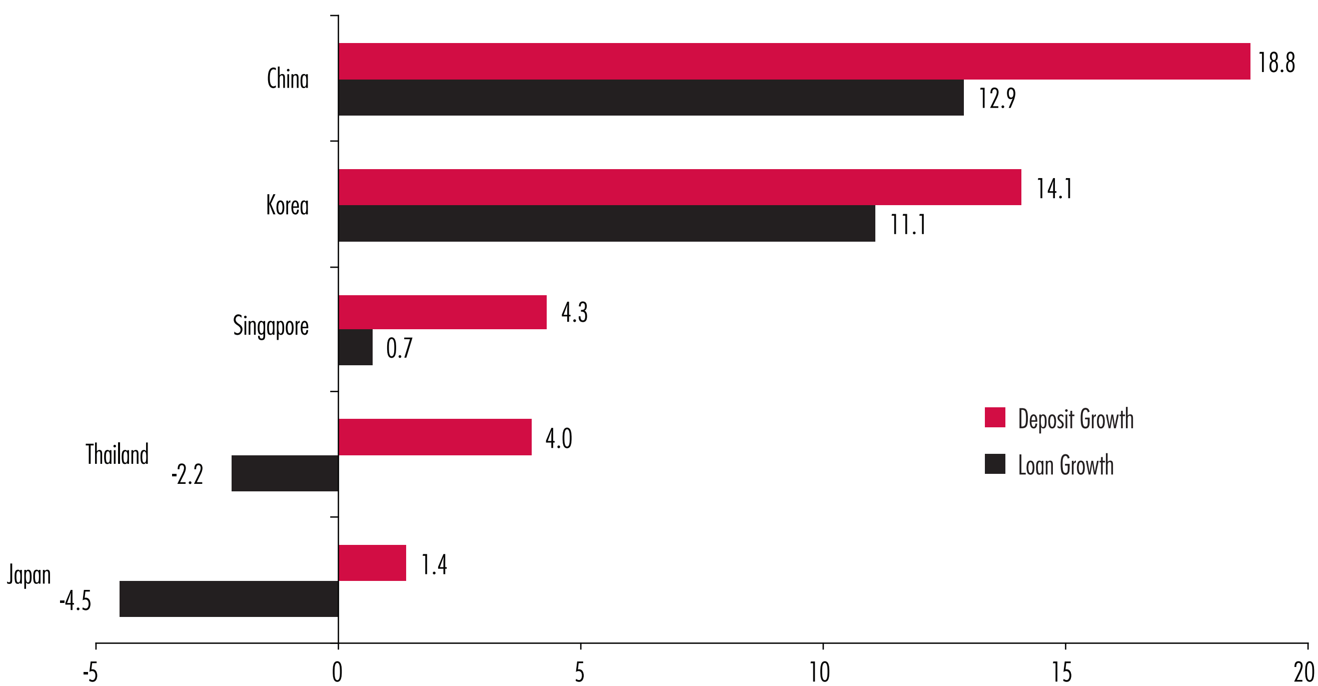
Law and Regulation: Uncertainty still surrounds the legal and regulatory treatment of the banking business in China, notwithstanding the ongoing reforms and the undeniable improvements in the institutional structure.

Risk Management: China recently has begun a migration to a five-classification loan-grading system that aligns better with international standards. The earlier four-classification system was seriously flawed, leading to endless speculation about the levels of non-performing assets and the inadequacy of loan provisioning. The universal acceptance and performance of the new system are yet to be demonstrated, as is the capacity of Chinese regulators to supervise its implementation.

Asset Quality: The combination of poor risk management, excessive policy-directed lending, inadequate prudential norms, and under-provisioning for writing off bad loans has left a legacy of non performing assets. Unfortunately, more effort has attempted to resolve the stock problem than the flow problem in the major SCBs. Although the banks' reported non-performing loans (NPLs) have fallen sharply during 2000-05, the story may be too good to be true. Unofficial estimates of NPLs still exceed officially reported levels. Moreover, lending grew rapidly in 2002-04 and the quality of these loans cannot yet be judged. Both the share still going to poorly performing state enterprises and the soundness of the surge in lending to households — for mortgages, cars, and credit cards — are unknown.

Chart 2. Asian Banking Market Growth Comparison

Loan and Deposit Growth (1999–2003 Compound Annual Growth Rate (%))



Source: Various Central Banks

Summary

In relying on foreign strategic investment to accelerate the restructuring of China's banks and to enhance their ability to compete, Chinese officials face a delicate trade-off: To what extent will they cede control of banks' operations to foreign interests to achieve better operational performance? Foreign participation offers domestic banks the prospects of better management practices, attractive opportunities for business cooperation, enhancement of their reputations in global and domestic capital markets, and injections of equity capital. The growing number of investments of this kind in the past two years illustrates the promise of partnership between foreign investors and Chinese banks.

Foreign investors confront their own delicate calculations. The rapidly growing Chinese financial services markets and the distributional advantages of associating with established Chinese banks create prospects for handsome profits. The problematic condition of many of the larger Chinese banks presents a less rosy picture, with concerns about their poor asset quality, dysfunctional corporate governance, and under-developed capacity to manage risk, as well as the unfavorable legal and regulatory environment in which they operate. In addition, the foreign investor has to be concerned about how to make its voice effective in the management and control of the joint venture, and how to extract itself from the investment when the time is either right or badly wrong.

The prospects are intriguing. If the Chinese Government continues to mitigate some of the potential obstacles — in particular, by establishing a legal system that supports banks more effectively, by limiting official intervention in banks' operations, and by devolving more management authority to the foreign partners — foreign investment in China's banking sector could raise rapidly the quality of China's financial services. Certainly, it promises to improve the performance of the banking system much more rapidly than simply relying on foreign banks to expand their low current market share.

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