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A preliminary assessment of the recent reforms of the Chinese Banking Sector: NPL reductions and Global expansion

Venezia, November 17th 2010

Executive Summary

In this article, we discuss the pace of transformation of the Chinese banking system by focusing on two main topics:

- The first one is the issue of Non Performing Loans (NPLs), given that historically Chinese banks have been plagued by political pressures to over-lend to state owned enterprises (SOEs), irrespective of their viability.
- The second one is the internationalisation of the Chinese banking system.

The banking reform strategy changed in the 2000s:

- Since 2003 the reform strategy switched to facing NPLs' roots, forcing banks to strengthen prudential and commercial-oriented lending and trying to cut the excessive linkages between SOCBs and SOEs, also through strengthened supervision. Results of the new strategy are positive, even if fragilities remain.

- Since 2005, Chinese banks attracted huge investment from foreign player. From 2007 the scenario has progressively changed: i) new Chinese regulations allowed foreign banks to go for organic expansion; ii) many foreign players sold their stakes in Chinese banks due to liquidity needs.

- From 2006, Chinese banks had started going global. It is likely that the major Chinese banks may be active players in the banking M&A market. This might divert banks' focus from completing the restructuring.

Financing by domestic non financial corporations in the first half of 2010 (% of the total)

Financing by domestic non financial corporations in the first half of 2010 (% of the total)

	2010H1	2009H1
Bank Loans[1]	80,4	86,9
Equities[2]	4,2	1
Government Securities[3]	5,4	5,5
Enterprise Bonds[4]	9,9	6,6

Notes:
1. Bank loans in this table include loans denominated in both domestic and foreign currencies.
2. Equity financing in this table includes financing through convertible bonds but it excludes financing by financial institutions on the stock market.
3. The financing volume of government securities in 2009 includes municipal bonds issued by the Ministry of Finance on behalf of local governments.
4. Enterprise bonds include enterprise bonds, corporate bonds, equity warrant bonds, collective bonds, short-term financing bills, and medium-term notes.

Source: The People’s Bank of China.

Milestones of the establishment of the Chinese Banking System

- The modern Chinese banking system was kicked off in 1978. It is possible to identify three main steps:
  - ✓As of 1978, China had a single bank (The People's Bank of China, PBOC). The spin-off of the commercial banking activity from PBOC was the trigger for the foundation of the four big SOCBs in 1978-1984. From mid 1980s, China allowed the establishment of other banks as the JSCB and the CCBs.
  - ✓A milestone of the Chinese banking system was the issuance of the Commercial Bank Law in 1995. The law specified that the government must not interfere with lending decisions. Notwithstanding that, the independence of the banks was compromised by the fact that the State Council was allowed to mandate policy lending and credit quotas to the SOCB and by frequent political pressures to push banks to lend to ailing state firms, irrespective of sustainability. This has inflated NPLs.
  - ✓ Until 2003 the PBOC was the Central Bank and the regulator, the lender of last resort and the ultimate shareholder (with the Ministry of Finance) of the SOCBs with conflicts of interest. In 2003, the PBOC was split up. Regulatory functions were transferred to the CBRC mandated to improve risk management and corporate governance at all banks. Since 2003, the CBRC promoted a new strategy for restructuring banks.

The banking landscape in China, 2009

The banking landscape in China, 2009

	Activity	*Number of Banks*	*Branches*	*Share of Assets*
SOCBs	Full	4	>70000	51
Postal Bank	Full	1	>35000	n.a.
JSCBs	Full	13	>6000	15
CCBs	Full	124	>5000	7
Foreign Banks	Full if locally incorporated.	29*	n.a.	2.3

Source: China Banking Regulatory Commission. *= Locally Incorporated

The Chinese Banking System in comparison to other emerging banking systems

- A shortly review of the recent evolution of the banking systems of the main emerging markets, highlights the Chinese banking system is quite peculiar in international comparison.
- Since the mid-1990s, emerging countries have moved to strengthen their banking systems. Reforms have followed a three-legged approach:
  - ✓ The first pillar has been consolidation. The step-up in the consolidation process has reduced the number of banks down by between 10 and 30% in the major emerging markets (Mihaljek, 2006). China, is quite an exception to this trend, as no evidence of domestic bank mergers is available.
  - ✓The second pillar was privatization. Privatization is relatively advanced in many emerging countries, even though Boehmer et al. (2005) suggest that governments often do not to disinvest completely. The most evident exception to the privatization trend is China where.
  - ✓ The third leg of such reforms was the opening to foreign banks, which showed pros and cons (see Bongini et al, 2009 for a critical discussion). The presence of foreign banks is extremely high in Central Eastern Europe and in Latin America, but lower in Asia. China, is the main exception to this trend, with foreign banks accounting for less than 2% of total banking assets.

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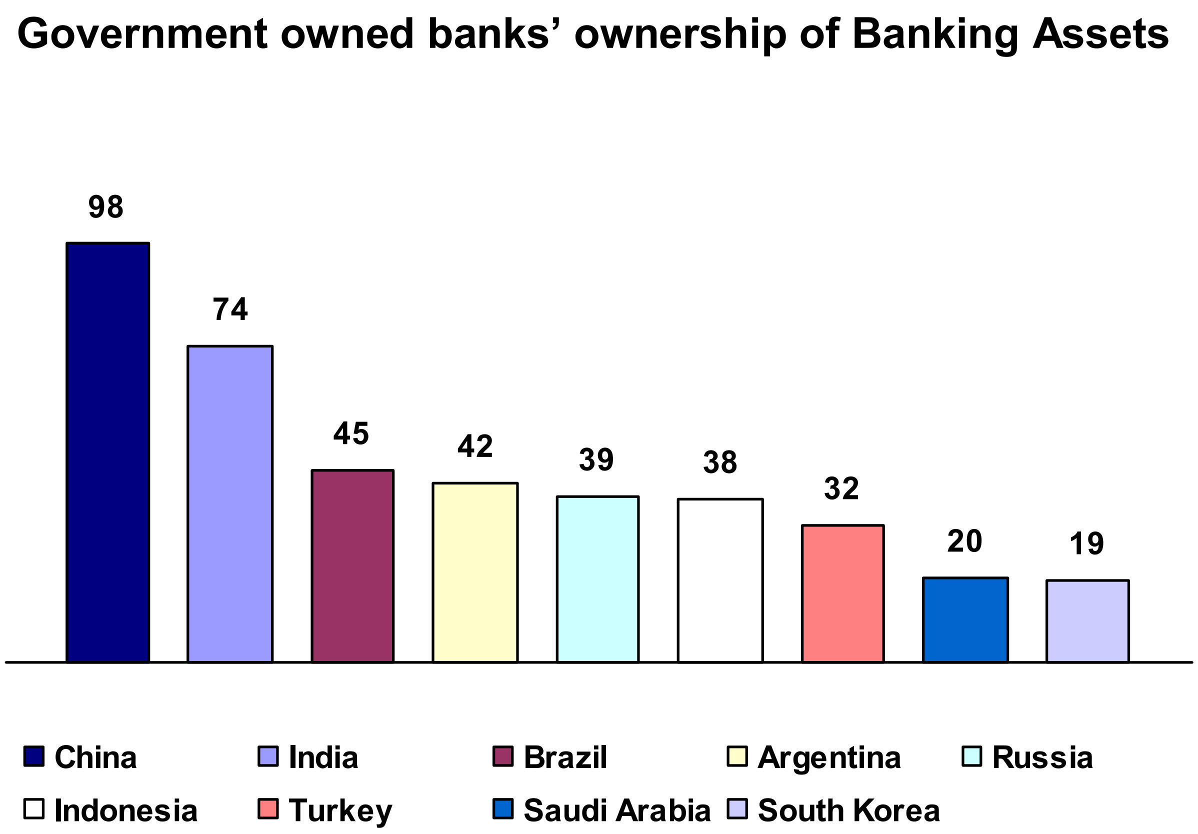
Share of Total Assets of the Top 5 Banks, 2008

Share of Total Assets of the Top 5 Banks, 2008

	Top 5 Banks
China	55
India	40.9
South Korea	73.1
Indonesia	40.4
Malaysia	69
Philippines	45.1
Thailand	62.2
Bulgaria	59.7
Croatia	72.6
Czech Republic	64.7
Hungary	54.4
Poland	51.2
Romania	62
Russia	42.4
Serbia	47.1
Slovak Republic	70.5
Slovenia	62.4
Turkey	62.5

Source: China Banking Regulatory Commission. *= Locally Incorporated Banks. ^: foreign banks refers to joint ventures banks

Government owned banks' ownership of Banking Assets



Source: Barth (2008)

Foreign Banks Share of Total Banking Assets

Foreign Banks Share of Total Banking Assets

	0-10%	*10-20%*	*20-40%*	*40-70%*	*70-100%*
Emerging Markets	China, India, Russia	Brazil	Argentina, Indonesia, South Africa	Korea	Mexico
Advanced Economies	Canada, Germany, United States	Australia, France, Italy		United Kingdom	5.5

Chopra, 2007

Share of Total Assets of the Top 5 Foreign Banks, 2008

	Top 5 Foreign Banks
China	<1%
India	5.5
South Korea	22.4
Indonesia	23.2
Malaysia	18.3
Philippines	11.7
Thailand	11.2
Bulgaria	59
Croatia	72.6
Czech Republic	64.7
Hungary	54.4
Poland	41.3
Romania	61.8
Russia	4.8
Serbia	43.8
Slovak Republic	70.5
Slovenia	24.5
Turkey	38.3

Source: China Banking Regulatory Commission. *= Locally Incorporated Banks. ^: foreign banks refers to joint ventures banks

The NPLs problem in China until 2003

- The principal problem of the Chinese banking system has been the huge NPLs.
- The consensus is that China state-owned banks have been lending excessively to unprofitable and ailing SOEs. This might depend on central and local governments pressures to save such firms (to reduce the risk of excessive unemployment potentially deriving from a wave of bankruptcy in SOE) or on inadequate lending procedures.
- We can identify two phases in this restructuring process. The first one focused on disposal of NPLs and lasted until 2003:
  - ✓ Policy Banks were established to shield SOCBs from pressures to over-lend to SOEs (1994)
  - ✓ The government engineered a 33bn USD recapitalisation of the SOCBs and established AMCs to buy 170bn USD of NPLs at book value from SOCBs (1999). Selling NPLs at book-value did not create any incentive to improve lending practices.
- The literature suggest that such strategy was unsuccessful because it was ineffective at lowering policy lending by SOCBs: the roots of NPL's proliferation

NPLs reduction: a three-pillars strategy since 2003 (i)

- Since 2003, the Chinese strategy for restructuring its banks changed. CBRC developed a roadmap based on the three pillars:

  ✓ Transformation of SOCBs into corporations to improve their corporate governance, with a permissive attitude towards IPOs to lay the basis for (minority) private shareholding, in order to put shareholders' pressure on managers.

  ✓ A new strategy for SOEs to reduce the pressures to save ailing companies. The State-Owned Assets Supervision and Administration Commission (SASAC) was established to turn selected strategic state companies into national champions. All the other SOEs were left to their destiny, even if local governments might take some of them under their protection. As well, most banks are developing SME strategies.

  ✓ Enhancing competition through interest rate liberalisation and opening to foreign banks. The government recognised that foreign competition is beneficial to modernise the system. Hence, it decided to open to foreign banks with the hope to ignite a learning by imitating effect.

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NPLs reduction: corporate governance

- The first pillar leveraged on reforms based on international best practices, to banks' loan assessment and risk.
  - ✓ Issue (2006) of Guidelines for the Corporate Governance of SOCBs
  - ✓ Improving public disclosure of bank performance, with reference, for instance to Annual Reports.
  - ✓ Banks allowed to issue subordinated bonds (and in 2005 hybrid bonds). In 2009, for instance, 32% of capital raised was through bonds, as compared with 17% in 2008, according to KPMG (2010).
- Furthermore, the CBRC has supported the IPOs of the SOCBs:
  - ✓ The government sponsored a final recapitalisation of SOCBs (45bn USD to BOC and CCB, and 15bn to ICBC), with additional sales and write-offs of NPLs at market value
  - ✓ The decline in the NPL ratio gave green light for IPOs by CCB (2005, 9.2bn USD); BOC (2006, 9.7bn and 2.5bn USD) and ICBC (2006, 21.9bn USD). Many other JSCBs listed since then. It is worth noticing that Rowe et al. (2009) find that board governance has significant impact on Chinese banks' performance.
  - ✓ The main laggard was ABC. ABC was granted more time to comply with CARs. In November 2008 it received 19bn USD recapitalization from the government and in January 2009 it transformed itself into a shareholding company. ABC officially completed the world's largest IPO in August 2010 with a total amount of about 22.1bn USD.

Financial Support Measures to the Chinese Banking Sector

Financial Support Measures to the Chinese Banking Sector

Capital Injection		
	USDbn	Recipient
1998	33	SOCBs abd China Development Bank
2003	45	BOC and CCB
2004	2	Bank of Communications
2005	15	ICBC
2008	19	ABC
NPLs Carveout		
	USDbn	Recipient
1999-2000	166	SOCBs abd China Development Bank
2004	51	BOC, CCB, Bank of Communication
2005	85	ICBC

Source: China Banking Regulatory Commission Bank, FitchRatings, Asian Development Bank

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NPLs reduction: reduce the pressures to save ailing companies

- One of the main roots of the excessive NPLs of Chinese banks was the excessive weight of SOEs in their credit portfolios and the limited lending to SMEs.

Access to credit of Private Sector Companies

	0 130USDth	130USDth 390USDth	390USDth 1.3USDmn	1.3USDmn 2.6USDmn	2.6USDmn 6.5USDmn	USD6.5+	All
No Credit	55	43	40	36	29	42	41
Bank Finance Only	14	23	28	35	44	36	29
Informal Finance only	20	18	15	12	10	8	14
Bank and informal finance	12	15	17	18	18	14	16

Source: OECD, National Bureau of Statistics of the People's Republic of China

NPLs reduction: lending to SMEs

- Lack of collateral and discrimination are the major hurdles for lending to SMEs.
  - ✓ Banks have traditionally lent against real estate collaterals and many SME lack firm use and land use rights. In China only an estimated 4% of bank loans are collateralised, versus nearly 70% in the United States (Han, 2007).
  - ✓ The government and regulatory authorities have encouraged for long time the financial institutions, particularly commercial banks, to improve their lending to SMEs. The percentage of SME loans of listed banks has grown from 22% in 2006 to 33% in 2009, according to Roland Berger (2010).
  - ✓ Over the longer term, further development of the CCBs would help to improve SMEs credit access since these banks are generally more oriented toward such businesses than SOCBs or JSCBs (Tay, 2006).
- According to Herd et al (2010) credit guarantees are key to improve SME access to bank loans. Less than 1% of SMEs in China receive guaranteed loans, compared with nearly 20% in Korea and Chinese Taipei, and nearly 40% in Japan (ADB, 2007b). One of the hurdles is that Chinese banks tend to demand that full or nearly full insurance coverage for loan issued under guarantee.

NPLs reduction: enhancement of competition

- Enhancement of competition strongly contributed to the new banking restructuring strategy:
  - ✓A moderate opening to foreign banks has been instrumental to foster modernization. Zhu et al. (2009) show that the risk management abilities of Chinese banks improve when the shareholding of the leading foreign strategic investors exceeds 15%.
- In 2004, interest rates were liberalized (only lending interest rates in rural areas remained capped):
  - ✓ According to Herd et al (2009), banks made little use of the allowed range. Notwithstanding the limited application, interest rate liberalization seems a competition enhancer.
  - ✓Heffernan and Fu (2008) show that the intensity of competition in bank lending in China increased after WTO accession and alongside with interest rate liberalization.
  - ✓Feyzioğlu, et al. (2009) find that interest rate liberalization discourages marginal investment, improve the effectiveness of intermediation and enhance the financial access of underserved sectors (as the private sector) without any major disruption.

A selected survey of the literature

- There is consensus over the positive impacts of the new strategy, but doubts over the sustainability of its results because the bias toward easy lending endures
  - ✓Dobson and Kashyap (2006) say that government influence is declining, but not over.
  - ✓In 2006 the Chairman of the Board of CCB complained of continued government interference in lending decisions, as reported by Herd et al. (2009).
  - ✓Kudrna (2007) suggests that prudential indicators are comparable to international averages only thanks to NPLs bail outs and ongoing credit boom.
  - ✓ Sun and Fang (2007) find that average TFP improved during 2001-2004, suggesting that the threat of entry has had significant efficiency effects on incumbent banks.
  - ✓ Allen et al. (2008) show that banks made considerable progress in reducing NPLs.
  - ✓ Yao et al. (2008) find that ownership reform and foreign competition have forced Chinese commercial banks to improve performance. They are cautious, because the improvement might be a by-product of massive government support.
  - ✓ Zhu et al. (2009) show that the decline of the NPL ratio mainly reflects the rapid growth of China's economy and benefits a lot from the massive restructuring of SOCBs.
  - ✓ Feyzioğlu (2009) find that Chinese banks have become more efficient during 2001–07. Nevertheless, most of them remain quite inefficient. Large banks tend to hoard deposits and operate beyond the point of diminishing returns to scale.
  - ✓ Yeung (2009) suggest that priority lending to SOEs was difficult to change.
  - ✓ Matthews and Zhang (2009) show that the average CCBs improved its productivity growth. Individual SOCBs and JSCBs did improve their productivity growth. Most other SOCBs and JSCBs lagged behind.

NPLs of the Chinese Banks

NPLs of the major Chinese Commercial Banks

	2003	2004	2005	2006	2007	2008	2009
Commercial Banks	17.4	13.2	8.9	7.5	6.7	2.4	1.6
SOCB	16.9	15.6	10.5	9.2	8.1	2.8	1.8
JSCB	6.5	5	4.2	2.8	2.2	1.3	1.0
CCB	15	14	7.7	4.8	3	2.3	1.3

Source: CBRC.

NPLs of the major Chinese Commercial Banks, RMB bn, %

	2003	2004	2005	2006	2007	2008	2009
Outstanding Balance	2.104	1.717	1.219	1.170	1.200	486	426

Source: CBRC.

SMLs and NPLs of the 5 major Chinese Commercial Banks

SMLs and NPLs of the 5 major Chinese Commercial Banks

NPLs	2007	2008	2009	2007	2008	2009
	%			Renminbi billion		
ABC	23.4	4.3	2.9	818	134	120
ICBC	2.7	2.3	1.5	111	104	88
CCB	2.6	1.5	2.2	85	83	72
BOCOM	2.1	1.9	1.4	22	25	25
BOC	3.1	2.6	1.5	88	87	74
SMLs	**2007**	**2008**	**2009**	**2007**	**2008**	**2009**
	%			Renminbi billion		
ABC	7.8	12.8	7.8	268	397	324
ICBC	5.7	5.2	4.0	232	237	228
CCB	6.9	5.7	4.1	227	217	200
BOCOM	5.1	4.4	2.7	56	54	50
BOC	5.1	4.9	2.8	144	159	139

Source: Annual Reports.

Migration Rates for the major Chinese Commercial Banks

Migration Rates for the major Chinese Commercial Banks

	Normal to SM or NPL			SM to NPL		
	2007	2008	H12009	2007	2008	H12009
BCOM	1,72	2,32	1,48	13,67	21,72	13,26
CCB	2,96	3,6	1,41	9,43	8,4	3,89
ICBC	3,5	4,6	1,3	10,4	9,3	6,7
BOC	2,62	3,65	1,28	10,79	8,02	4,99
IND	5,53	1,9	1,13	26,29	13,04	10,64
MERCHANTS	4,06	2,52	1,01	15,99	11,89	6,3
HXB	12,02	5,92	1	17,06	14,41	9,8
MINSHENG	1,23	3,48	0,96	26,96	16,47	7,61
SZDB	1,46	2,78	0,61	62,22	1,9	28,1
SPDB	3,25	4,07	0,59	20,07	22,23	8,45
CITIC	1,2	1,42	0,44	6,12	6,94	4,67
BoB	1,15	7,71	0,16	2,84	0,39	0,19
AVG	3,39	3,66	0,95	19,49	11,23	8,72

Note: Five Tier Migration Rates Reported by Chinese Listed Banks. H1 2009 not annualized

A preliminary assessment of the recent NPL reduction strategy

- Overall, putting together the data on SMLs, on NPLs and on migration patterns, it seems likely that a share of the new loans extended in 2009 might have been used by borrowers to repay existing problematic loans, hence postponing the realisation of fragilities.

Capital Adequacy of the major Chinese Commercial Banks

Capital Adequacy of the major Chinese Commercial Banks

	2003	2004	2005	2006	2007	2008	2008
Number of Banks	8	30	53	10	161	204	239
Share of total Assets (%)	<1	48	75	77	79	100	100

Source: CBRC

Chinese securitizations

- Fitch (2010b) suggests that an increasing amount of credit has been shifted off of Chinese banks' balance sheets via informal securitisation (ie the re-packaging of loans into investments products for sale to investors).

- Adjusted for informal securitisation activity, Fitch estimates that the net amount of new loans extended in H110 was 28% above the official figure. Credit-backed investment products are believed to carry an implicit commitment from banks to repay investors upon the products' maturity.

- However, these obligations are not included anywhere in financial statements, and hence represent a hidden call on liquidity. While China's large, highly liquid banks may be able to manage these obligations, smaller banks could encounter strains.

P&L and selected KPIs of the major Chinese Commercial Banks

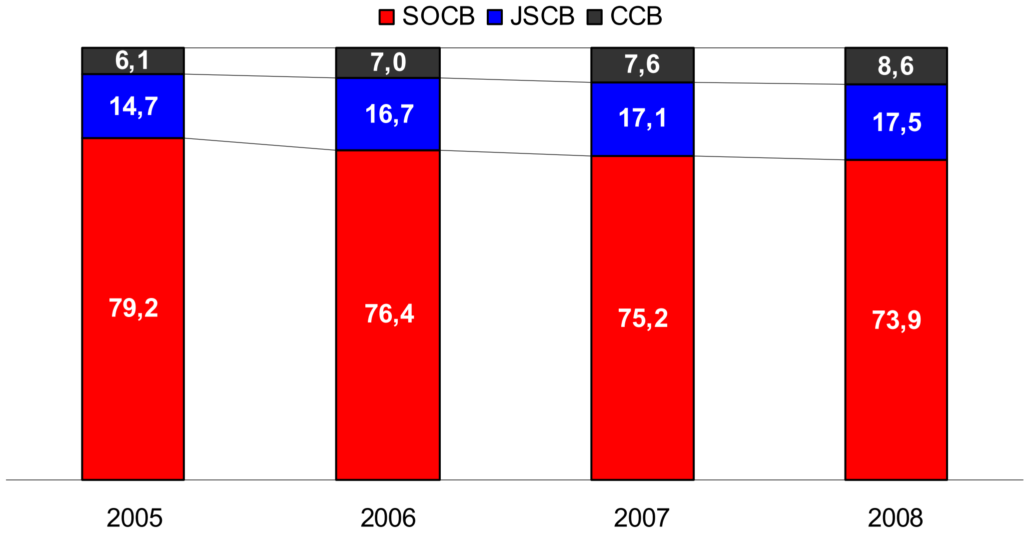
P&L and selected KPIs of the major Chinese Commercial Banks

	2003	2004	2005	2006	2007	2008	2009
Assets (% of total assets)	**63,3**	**67,2**	**68,0**	**67,6**	**68,4**	**66,4**	**65,9**
Loans	**9.796.121**	**12.266.276**	**13.567.841**	**15.357.989**	**16.985.969**	**19.747.614**	**26.490.872**
% changes		25,2	10,6	13,2	10,6	16,3	34,1
Net interest income	**375.355**	**453.739**	**516.254**	**636.759**	**929.722**	**1.108.804**	**1.062.975**
% changes		20,9	13,8	23,3	46,0	19,3	-4,1
Non-interest income	**50.716**	**71.687**	**75.377**	**99.888**	**180.310**	**235.341**	**276.087**
% changes		41,4	5,1	32,5	80,5	30,5	17,3
Total operating income	**430.523**	**524.804**	**591.629**	**736.138**	**1.110.032**	**1.344.145**	**1.339.062**
% changes		21,9	12,7	24,4	50,8	21,1	-0,4
Operating expenses	**240.223**	**281.228**	**316.717**	**382.287**	**467.433**	**543.723**	**572.159**
% changes		17,1	12,6	20,7	22,3	16,3	5,2
Risk provisions	**73.063**	**83.905**	**81.190**	**108.115**	**142.603**	**252.528**	**134.746**
% changes		14,8	-3,2	33,2	31,9	77,1	-46,6
Operating profit	**116.622**	**168.148**	**200.871**	**256.446**	**488.441**	**528.525**	**631.116**
% changes		44,2	19,5	27,7	90,5	8,2	19,4
Profits after tax	**88.939**	**107.724**	**135.413**	**186.734**	**326.299**	**418.582**	**497.257**
% changes		21,1	25,7	37,9	74,7	28,3	18,8
Cost Income (%)	**55,8**	**53,6**	**53,5**	**51,9**	**42,1**	**40,5**	**42,7**
Risk Provisions on Total Loans (bp)	**74,6**	**68,4**	**59,8**	**70,4**	**84,0**	**127,9**	**50,9**
NII/Operating Income (%)	**87,2**	**86,5**	**87,3**	**86,5**	**83,8**	**82,5**	**79,4**
Loans/GDP (%)	**1,14**	**1,14**	**1,08**	**1,08**	**1,01**	**0,99**	**1,20**

Source: Selected bank's annual reports. Data refer to China Construction Bank, Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China, Bank of Communication, Merchant Bank, Minsheng Bank, Shanghai Pudong Development Bank, Citic Bank, Industrial Bank, Hua Xia Bank, Shenzen Development Bank.

Contribution of selected categories to the Profits of the Chinese Commercial Banks (%)

Contribution of selected categories to the Profits of the Chinese Commercial Banks (%)



Source: Herd et al (2009), Almanac of Banking and Finance in China, CBRC

Operating profits and LLCR

- Strong operating profits are a buffer to absorb potential increase of risk provisions without biting into their capital ratios:
  - ✓ Provision jumped from 84 bps to 128 bps between 2007 and 2008, without limiting profit growth
  - ✓ On this topic, it is worrying that impairment charges have decreased to 51 bp in 2009, in a bad economic scenario, with reduction for all major banks.
  - ✓ According to Fitch (2010), while asset quality contributed to this lowering of credit costs, it might also be an unintended effect of the new CBRC rule that requires banks to keep loan loss reserve coverage above the 150% level: banks already above such level might have reduced their charges, even with decreasing corporate profits, to sustain their operating profit and keep the growing trend.
  - ✓ In fact, it is possible to notice that the provisioning ratio for the SOCBs and JSCBs combined rose from nearly 20% at end-2003 to over 155% by end -2009.

- Entry options in China for Foreign banks
  - Minority M&A
  - Establishing a local subsidiary
  - Opening branches

Foreign Investment in Chinese Banks until 2008

Foreign Investment in Chinese Banks until 2008

Invested Bank	**Foreign Presence**	**Investment at the time of buying (USD mn)**
Industrial and Commercial Bank of China	Goldman Sachs (5.8%), Allianz (3.2%), and American Express (0.8%)	3800
Bank of China	Royal Bank of Scotland (9,6%), Merryl Linch (2,5%), UBS (1,6%) and Temasek (4,8%)	6700
China Construction Bank	Bank of America (8,5%) and Temasek (6%)	5500
Bank of Communications	HSBC (19.9%)	1750
Citic	BBVA (5%) with an option to increase to 9.9%	501
Shanghai Pudong Development Bank	Citibank (4.6%)	72.5
China Minsheng Banking Corporation	IFC (1,1%) and Temasek (4,6%)	123.5
Industrial Bank	Hang Seng Bank (15.6%) and IFC (4%)	260
China Everbright Bank (CEB)	Asian Development Bank (3,3%).	20
Guangdong Development Bank (GDB)	Citigroup (20%) and IBM (4.74%) plus local partners (60%)	3100
Shenzen Development Bank (SDB)	New bridge Capital (17.9%) and GE Consumer Finance (7%)	249
Hua xia Bank	Deutsche Bank (9.9% and may increase to 20%) and Sal Oppenheim (4,1%)	270
Bohai Bank	Standard Chartered (19.99)	123
Bank of Beijing	ING Bank (19.9%) and the IFC (5%)	270
Bank of Shanghai	HSBC (8%) and the IFC (7%)	112.9
Tianjin City Commercial Bank	Australia and New Zealand Banking Group (19.9%)	120
Dalian City Commercial Bank	Rumours about Bank of Nova Scotia (20%) and the International Finance Corp (5%)	370
Hangzhou City Commercial Bank	Commonwealth Bank of Australia (19,9%) and the ADB (5%)	106
Nanjing Commercial Bank	IFC (15%) and BNP Paribas (19.2%)	113.4
Jinan City Commercial Bank	Commonwealth Bank of Australia (11% with an option to expand that to 20%)	17.3

Source: Press and Company reports

Main Rules for Foreign Banks in China

Main Rules for Foreign Banks in China

WFFB and JV	Not-locally incorporated foreign banks
Only commercial banks which have assets over 10bn USD and have had a representative office for at least 2 years can control WFFB or form a JV	Can establish branches only where a representative office has been established for at least 2 years, provided total assets are over 20bn USD. If more than one branch is established, one branch must be designated for the overall management of all branches
Every branch must have a working capital of 100mn RMB (12.5mn USD) (Total branches' working capital must be below 60% of the bank's capital). Minimum paid-up registered capital is 1bn RMB (125mn USD)	Every branch must receive a working capital amounting to no less than 200mn RMB (about 25mn USD). Every branch must have: 30% of its operating capital in interest banking assets. RMB operating capital and reserves equal to no less than 8% of its RMB risk assets; a current ratio of no less than 25% and no more total domestic liabilities
WFFB and JV which have been doing business in China for 3 years and have been profitable for two consecutive years may engage in almost all banking activities	Branches cannot carry out bank card and RMB' business for PRC citizens. They may receive time deposits from them for an amount of no less than 1mn RMB each.

Source: China Banking Regulatory Commission

Foreign banks in China

Foreign banking establishments in China (As of end-2009)

	Foreign banks	Wholly Foreign owned banks	Joint venture banks	Wholly Foreign owned Finance companies	Total
Locally incorporated institutions (LII)		33	2	2	37
LII branches and subsidiaries		199	7		206
Foreign bank branches	95				95
Total		232	9	2	338

Source: CBRC

Foreign bank operations in China (2003-2009)

	2004	2005	2006	2007	2008	2009
Number of Institutions	188	207	224	274	311	338
Assets (RMB 100 Million)	5823	7155	9279	12525	13448	13492
% of total banking assets	1.8	1.9	2.1	2.4	2.2	1.7

Source CBRC

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Chinese banks go global (i)

- The first wave of Cross-Border M&A activity in Greater China occurred from 1993 to 2005, with an average of a deal a year and all deals involving Chinese and Hong Kong or Macau banks.
- The second wave started in 2006, with 11 deals in 2006-2008, 6 of which outside Greater China (BCG, 2008). In absolute terms, stocks invested abroad by Chinese banks, which stood at 12.3 billion USD by the end of 2006, have reached 26.8 billion USD by the end of 2008.
- To keep pace with economic and financial globalization and to meet the needs of Chinese enterprises for cross-border financial services, many Chinese banking institutions redesigned their business strategies to broaden their global presence in order to better serve their customers or tap the opportunities provided by international markets.
- By the end of 2009, 5 commercial banks have set up 86 branches and subsidiaries outside China, and acquired or invested in 5 foreign banks.

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Chinese banks go global (ii)

- BOC made no new acquisitions so far, even if about 20% of its profit come from oustide Mainland China, including Hong Kong and Macau.
- CCB, as well, has been a very limited M&A players, with uniquely the acquisition of Bank of America (Asia) in 2006.
- ICBC, instead, has branches/offices in various locations. Through its 1998 purchase, with BEA, of Hong Kong–based NatWest Securities Asia, renamed ICEA Finance, ICBC entered IB. In January 2010, BEA bought out ICBC. In April 2000 ICBC bought Union Bank of Hong Kong and renamed it into ICBC (Asia). In 2007, it bought Bank Halim Indonesia renamed PT Bank ICBC Indonesia; in March 2008, it bought 20% of South Africa' Standard Bank; in June 2009 it bought 70% of the Canadian unit of Bank of East Asia (Hong Kong); and in April 2010, it bought 97% of Thailand's ACL bank.
- Minsheng Bank invested 120 mln USD to acquire 9.9% (being prepared to reach 20%) of UCBH, the holding of United Commercial Bank, specialized in serving the Chinese community in the US and US companies investing in China. In 2008, UCBH got a $300 million investment from the TARP. Minsheng tried to acquire UCB to protect its original investment. But the application was not approved by the Fed. UCB was shut down and sold to Pasadena's East West Bancorp. Minsheng posted a loss of more than $120m.
- China's financial arms have been active shortly before the financial crisis. Moreover, during the worse of the financial crisis Chinese banks were rumored of various biddings. Rumors were not confirmed but they support the idea of Chinese players een by the market as potential bidders.

What accounts for push to internationalization of Chinese banks? (i)

- If we look at market cap and availability of funds, cross-border deals of Chinese banks are not an anomaly. China has 4 banks in the top 10 by market capitalization. Chinese banks have a huge availability of foreign exchange and liquidity. Listed banks might go for paper based transactions thanks to their positive valuation arbitrage in terms of multiples.
- On the other hand, the economic rationale for the cross border acquisition is not fully clear, given the level of development of Chinese banks and the foreseeable growth path of the Chinese market as compared to other banking markets.
- According to BCG (2008), the most frequently mentioned strategic rationales reported by Chinese banks for cross-border M&A deals are deploy excess funding, follow customers overseas and become a global company, adhere to national directives, extend product services and offerings and import skills within China.

What accounts for push to internationalization of Chinese banks: Acquiring capabilities / enhancing skills

- Acquiring capabilities / enhancing skills:
  - ✓This is crucial for Chinese banks, because so far the domestic market is mainly focuses on plain vanilla products and on traditional retail and commercial customers.
  - ✓Out of a CIB revenue pool of roughly 1 trillion Renminbi, 90% of the total is related to traditional loans, deposits and cash management. According to BCG (2008), a traditional Chinese bank extract 83% of its wholesale banking revenues from loans and financing, while a typical full service bank generates less than 20%. The large banks might wish to diversify their business towards more fee generating businesses.
  - ✓Hence, cross-border M&A is a possible strategy to acquire the competencies, through selected acquisition of producers or specialist mid-sized banks.

What accounts for push to internationalization of Chinese banks: Chinese corporate venture abroad

- Chinese corporate venture abroad:
  - ✓Chinese banks want to follow them overseas (and become global institutions). Chinese banks plan to copy foreign banks that have conducted cross-border M&A and rolled out their business model abroad to the benefit of their customers.
  - ✓Even in this case, cross-border M&A might work through acquisition of mid-sized banks in countries that are principal destinations of the Chinese export of industrial FDI.

What accounts for push to internationalization of Chinese banks: risks

- It is consensus, though, that cross-border M&A are complicated:
  - ✓ extremely challenging for management teams not used to such operations.
  - ✓ enormous regulatory might emerge during a cross-border banking M&A transaction.
- There are still tremendous opportunities to be tap in the domestic market:
  - ✓ The domestic market is growing at very strong pace and it is still relatively underdeveloped, with banking revenues expected to grow at a solid pace in the next few years, due to economic growth and to the spread of new products/services.
  - ✓ The competitive presence of foreign bank is, so far, extremely limited. While, the additional pressure put on China's large banks by JSCBs and CCBs, is stronger and is hitting the market shares of SOCBs. Cross border deals might de-focus from defending the domestic market.
- Finally, the timing of cross-border M&A from Chinese banks could be dangerous if it triggers a defocus from restructuring and from streamlining the credit approval processes.