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The Rise of Foreign Investment in China's Banks—Taking Stock

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Abstract

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The recent wave of foreign investment in China's banks and the prospects of further opening of the banking sector under the WTO agreement suggest that foreign banks are likely to play an increasingly important role in China. This paper takes stock of the involvement of foreign banks in the Chinese banking sector in the perspective of international experience. While in most other countries foreign bank entry took the form of direct takeover or majority shareholding, foreign investments in China's banks have been minority shareholdings with very limited management involvement. The paper concludes that China appears to be well positioned to benefit from further opening of the banking sector to foreign investors. International experience suggests that greater competition from and participation of foreign banks can in general bring important benefits if appropriate incentives and sufficient opportunities are created.

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I. INTRODUCTION

Banking reforms are at the core of China's strategy to improve the intermediation of its large private sector savings. As part of the financial liberalization program, reforms in the banking sector have been implemented over the last two decades, replacing the monobank system with a multilayered system that separates commercial lending and central banking functions. Considerable progress has been made in restructuring three of the four major state-owned commercial banks (SCBs) and, by end-2005, all three banks announced the selection of major foreign financial institutions as strategic investors with minority ownership stakes. The three banks have also recently completed initial public offerings (IPOs). Opening the banking sector to foreign competition is part of that broader strategy by the Chinese authorities to enhance the efficiency of banking sector through various channels including greater financial innovation and improving corporate governance in banks.²

Increasing foreign participation has been one of the key trends in the Chinese banking system in recent years. Foreign banks do business in China either directly through their own branches and subsidiaries or indirectly as minority investors in Chinese banks. The indirect participation has grown rapidly in recent years, particularly in 2005, as almost all major Chinese banks now have a foreign strategic investor. Since June 2004, foreign investors bought over US\$17 billion worth of shares in Chinese banks.³ This paper takes stock of the involvement of foreign investors in the Chinese banking sector, drawing on international experience with foreign banks in other emerging markets. Direct participation has remained relatively small, but it is likely to grow over time as remaining restrictions are eliminated effective December 11, 2006 under the WTO agreement (Box 1).

Unlike many other emerging market or transition economies, China's domestic banks have well-established and extensive presence, thus direct market penetration by foreign banks may not be easy. While in most other countries, foreign investment took the form of direct takeover or majority shareholding, foreign investment in China's banks has taken the form of minority shareholding with very limited management involvement. Thus, how much influence foreign investment will have on the domestic banks' core business—and, most importantly, risk management—is therefore debatable. Many of the strategic investors have also entered into separate arrangements with the domestic banks in noncore businesses such as credit cards, which brings both benefits and risks. In these areas, the foreign banks' technological advantage and global networks can increase efficiency and help to expand these markets.

² Details of the progress made by China in banking sector reforms can be found in Podpiera (2006).

³ This excludes the most recent agreement, finalized in late 2006, in which a consortium led by Citigroup (and including domestic participants as well) acquired an approximately 85 percent stake in the Guangdong Development Bank for about \$3.1 billion.

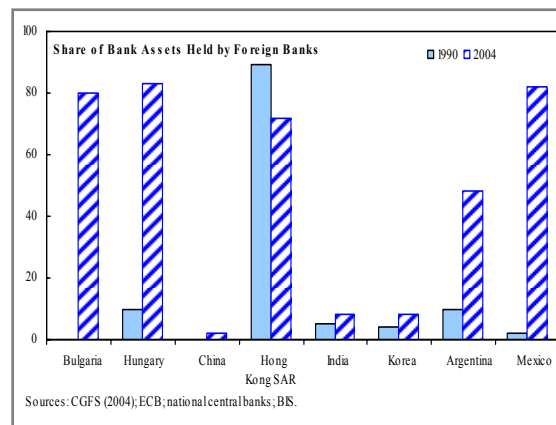
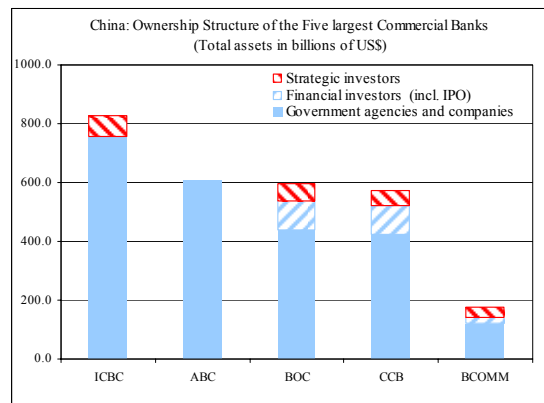
Overall, the main lesson of international experience is that foreign banks can bring important benefits if appropriate incentives and sufficient opportunities are created. In any event, with or without foreign participation, China's banking system needs to continue to forge ahead with fundamental reforms in internal control, risk management, and corporate governance, to improve the intermediation of China's large pool of domestic savings.

II. FOREIGN BANKS IN CHINA

So far, foreign banks' direct activities have remained restricted. As of end-September 2006, foreign-funded banks accounted for 1.8 percent of total banking assets. Similar to other types of banking institutions, foreign-invested commercial banks are supervised and regulated by the China Bank Regulatory Commission (CBRC), and there have been important restrictions on their RMB-denominated operations, mainly in providing banking services to individuals.

More recently, foreign banks are starting to play a more substantial role as minority investors in domestic banks. There have been three rather distinct phases in this entry into Chinese banks.

- 1996–2001: isolated transactions with niche players like the Bank of Shanghai and Nanjing Commercial Bank. Foreign portfolio investors were mainly multilateral financial institutions who had no active operational role.
- 2001–2004: with the conclusion of China's WTO negotiations, foreign banks' entry increased. Entry was limited to joint-stock commercial banks and city banks in major cities. The large state-owned banks were in poor financial situation and foreign investors were mostly interested in potentially the most profitable geographical areas. Smaller banks also required smaller investments.
- Late 2004-present: foreign investors' interest intensified further, as reforms in the large



state-owned banks gathered speed and as the government began to permit higher foreign ownership.⁴

Since 2004, foreign strategic investors have entered in four of the largest five banks. The 2004 purchase by Hong Kong and Shanghai Banking Corporation (HSBC) of a stake in the Bank of Communications (BoCom), China's fifth largest bank, was the first major transaction. Since June 2005, foreign investors have invested or committed to invest over US\$14 billion in the three large state-owned commercial banks, and all three have acquired strategic investors: the Bank of America (BOA) in China Construction Bank (CCB), a consortium led by Royal Bank of Scotland (RBS) in the Bank of China (BOC), and Goldman Sachs led investor group in the Industrial and Commercial Bank of China (ICBC). Table 1 provides an overview of these investments.

Box 1. Opening the Banking Sector to Foreign Investment in Late 2006

In its WTO accession agreement, China has committed to a phased-in liberalization of foreign bank access to its banking market, with the aim to fully open its banking sector to foreign bank participation, without geographic or client restrictions, effective December 11, 2006.

Foreign banks and branches would be permitted to engage in a similar range of financial services as Chinese banks, and they would be treated and regulated in the same way as domestic banks. Specifically, for conducting local currency business, geographic restrictions were to be lifted as of December 11, 2006. With regard to commercial presence, there would be no geographic restrictions for conducting foreign currency business. In addition, foreign financial institutions licensed to provide local currency services in one region would be able to do so in any other region that has been opened for such business. As of December 11, 2006 all non-prudential market access constraints on foreign banks which restrict ownership, operation, and juridical form of foreign financial institutions, including on internal branching and licenses were also be lifted.

In November 2006, the authorities issued *Regulations for the Administration of Foreign-Funded Banks*, which should implement the WTO commitments. As a result of these new regulations, access to Chinese banking market will be easier, but building a larger presence could take some time as foreign banks must satisfy certain requirements before they can be granted approval for offering full domestic currency services to Chinese individuals. To fulfill these requirements, foreign banks must establish an incorporated affiliate in China with minimum capital of RMB 1 billion and each branch must have a minimum capital of RMB 100 million. Furthermore, foreign financial institutions applying to engage in local currency business must have three years of business operation experience in China and have been profitable for two consecutive years prior to applying.

⁴ Ownership by a single foreign investor is limited to 20 percent, while the combined share of all foreign investors in one bank is limited to 25 percent.

The structure of the four partnership arrangements has been similar:

- The strategic investor is a major international commercial bank with substantial commercial banking expertise. The only exception is Goldman Sachs, the main investor in ICBC, which is a leading investment bank without major commercial banking operations. ICBC explains this investment as intended to aid it in developing wealth management business and its strategy to keep consumer finance in-house.
- With ownership shares between 9 and 20 percent, the strategic investors have no management responsibility, but have the right to nominate one or two members of the Board of Directors, which has more than 15 members, on average.
- Direct investment safeguards are relatively limited. Bank of America is covered only for the restatement of 2004 financials, RBS and Goldman Sachs against a decline of book value below end-2004 and end-2005 book value; respectively.
- Strategic investors have started or plan to start cooperation in one or more non-core banking business. Credit card business is one popular area, and HSBC's agreement with the Bank of Communications can serve as an example. The credit card business unit is managed as a joint venture and the existing agreement is to give HSBC a 50 percent share once regulations permit spinning off the unit from the bank. RBS has a similar arrangement with the BOC, and Bank of America is negotiating credit card cooperation with the CCB. Similar agreements may be developed in investment banking, wealth management, or information technology.

Foreign ownership participation in smaller Chinese banks has increased substantially as well. In 2004, five Chinese banks, including BoCom, Shenzhen Development Bank, and Xi'an City Commercial Bank, brought in foreign strategic investors, doubling the number of Chinese banks with foreign equity participation. In 2005 and early 2006, a number of further arrangements with strategic investors were announced, including China Minsheng Banking Corporation, Huaxia Bank, Bohai Bank, Bank of Beijing, and Hangzhou City Commercial Bank (Table 2).

There are several reasons that may have motivated the interest of foreign strategic investors in the smaller banks. While there are substantial risks in entering the Chinese banking sector as a strategic investor, (including in corporate governance, legal system, reliability of financial information, and regulatory treatment), foreign interest may have been influenced by: (i) strong growth of the Chinese economy, which creates profitable opportunities; (ii) a large banking sector, relative to the economy, allows considerable space to expand market share; (iii) recent progress in reforming the banking sector, improving regulation and supervision, and the WTO commitment to open the banking sector to foreign competition as of December 11, 2006; and (iv) the "global balance sheet" argument—because of the global

scale of operations of major foreign banks, the return on investment in technology is greater and once the technological platform has been installed, the marginal cost of extending the platform and integrating the processing of transactions to a regional center is very low.

Nonbank investments into China's banking system have increased as well (Table 2). In many cases, they are the leading strategic investor in the investment consortia (for example, American Express and Allianz in the ICBC). Large financial investors have entered as well—Temasek, the investment arm of Singapore's government, has invested approximately US\$4.5 billion in the CCB and BOC (directly and in IPOs), and China's National Social Security Fund has invested over \$1 billion in BOC shares. In addition, public listing of shares in overseas markets increases transparency of the banks and provides a mechanism for investors to evaluate their performance.

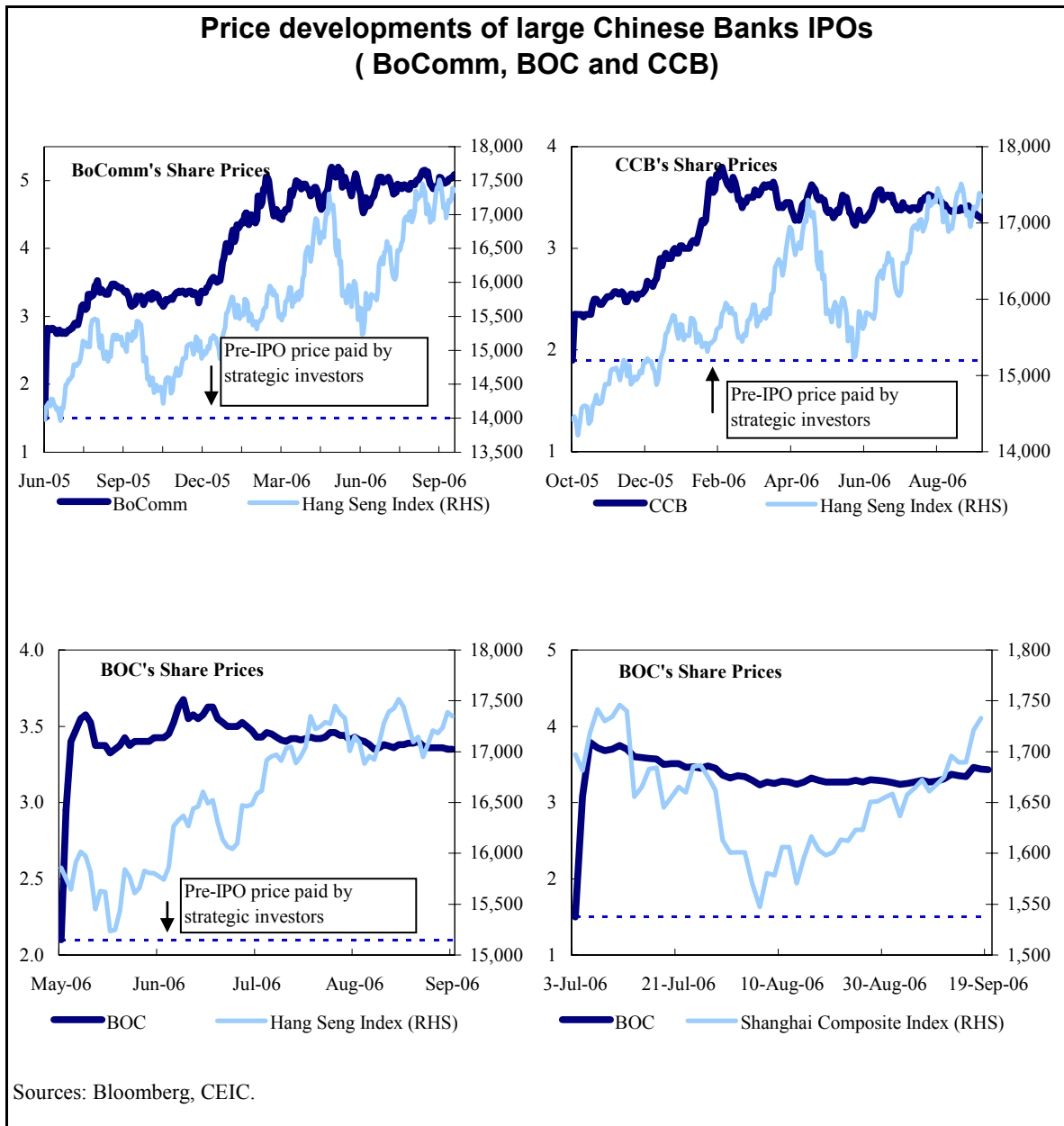
The pricing of foreign investments into China's banking system has varied. For instance, relative to BoComm's pre-IPO price paid by foreign strategic investors, BoComm shares are currently trading at about 300 percent higher, suggesting that strategic investors made significant paper profits. Similarly, CCB's and BOC's IPO price is currently at about 170 percent and 160 percent relative to pre-IPO prices paid by foreign investors, respectively.⁵ However, several factors can influence the pricing for foreign investors. First, the entry of the strategic investor itself may have increased the potential market value by raising investor confidence. Second, the cooperation with strategic investors may signal potentially larger future profits for both sides. Third, strategic investors are locked-in for a period of time, mostly for 3 years, so the implied profit cannot be realized.

So far the involvement of foreign investors in improving China's banks has been limited. Foreign investors have: (i) increased bank capital, even though part of their investment went to SAFE Investments as foreign investors partly bought existing shares; (ii) provided credibility needed to launch IPOs of relatively large size; (iii) induced improvements in corporate governance and management, with some board seats being occupied by candidates nominated by the foreign investors; and (iv) provided limited technical assistance.

Overall, it remains unclear whether foreign strategic investors have sufficient incentives and opportunities to improve the core operations of Chinese banks. The ownership shares of foreign strategic investors are relatively small and their management involvement is minimal. While the entry of foreign investors will undoubtedly bring some benefits, including greater transparency and some knowledge transfer, the structures of the strategic agreements so far do not give strong assurances that the investors will improve credit risk management, which is at the core of recent and potential future problems of Chinese banks. Operations in non-core areas by strategic partners can be lucrative irrespective of the bank's overall

⁵Investors bought pre-IPO interests in CCB at about 1.15 to 1.19 times book value, but the CCB went public at about 2.5 times book value. BOC's recent IPO delivered a pricing of about 2.1 times book value, pre-IPO prices paid by strategic investors were lower at about 1.17 times book value.

performance. Almost all strategic investors have started joint operations in one or more non-core areas, with potentially larger involvement. Importantly, the return on such investment is not fully dependent on the bank's overall performance, which will hedge some of the risks mentioned above and also weaken incentives for the investors to push hard for changes in the core commercial banking business. The authorities need to ensure that: (i) no value is lost in the side cooperation agreements, because the banks will all be listed and there could be major legal and reputation issues; and (ii) foreign investors have strong incentives to fully engage in improving core banking business.



III. LESSONS FROM INTERNATIONAL EXPERIENCE

International experience does not offer much insight into what effects foreign investors may eventually have on the performance of Chinese banks. Most studies have focused on analyzing the impact of foreign bank entry as fully-owned subsidiaries or controlling shareholders of domestic banks. The recent form of foreign investor entry into Chinese banks is fairly unique as foreign banks take only a relatively small minority stake and on current plans this is likely to be the case for some time. While almost all banks have a strategic investor, the amount of banking assets controlled by foreign banks is low.⁶ The level of involvement in the management is also limited.

That said, international experience suggests a positive impact of the entry of foreign banks on efficiency (Box 2). For instance, relaxed branching restrictions within states in the United States have been associated with increased credit availability, enhanced bank efficiency, and faster economic growth (Jayartne and Strahan, 1996 & 1998). The implication of this experience for foreign banks investment is that foreign banks may indeed have a positive effect on the average efficiency of the banking sector in the destination country, because they are likely to be among the most efficient in their country of origin. The benefits of foreign bank entry may depend on the level of development of the host country. For emerging market and developing economies, like China, foreign entrants tend to be more efficient than incumbent banks and stiffer competition seems to improve overall bank efficiency. Experiences with foreign banks participation tend to be especially positive when financial firms expand into markets where they have acquired specific expertise and introduced more sophisticated risk management techniques. Other studies that explored the relationship between foreign bank entry, market structure, and interest rate spreads and margins (Barajas, Steiner, and Salazar, 2000 and Demirguc-Kunt, Laeven, and Levine, 2004) also find a positive relationship between foreign bank entry and intermediation efficiency.

One concern in many developing countries is that foreign banks skim the best customers and leave lower quality customers to domestic banks, which in turn are left with high-risk portfolios and are unable to provide access to credit to more risky clients. While there is some evidence that foreign banks at least initially offer higher-quality services and are able to successfully compete for the best customers, there is no conclusive evidence showing that this is not an efficient outcome or that it leads to financial stability issues. In a recent attempt to address this issue, Detragiache, Tressel, and Gupta (2006) showed that, in poor countries, a stronger foreign bank presence is robustly associated with less credit to the private sector and that in countries with more foreign bank penetration, credit growth is slower and there is

⁶In China, foreign financial institutions hold between 10 and 25 percent of the equity of the three largest Chinese banks. In total, foreign interests in Chinese banks (state-owned, joint stock, commercial banks and banks) amount to about \$18 billion.

less access to credit. However, they did not find any adverse effects of foreign bank presence in emerging market economies, so this concern may not be relevant for China. Moreover, China's main problem has been inefficient banking intermediation rather than lack of access to credit overall.

The international ownership of banks also has a significant impact on bank spreads and profitability. Foreign banks, specifically, realize higher interest margins and higher profitability than domestic banks in developing countries. This finding may reflect the fact that in developing countries a foreign bank's technological edge appears to be strong enough to overcome any informational disadvantage in lending or raising funds locally. Foreign banks, however, are shown to be less profitable in industrial countries, where they may not have a technological edge.

Box 2. Foreign Investment in Domestic Banks: Selected Country Experience

- *Malaysia* is an example of an emerging market with a relatively large and well-established foreign presence in the banking sector. Detragiache and Gupta (2004) compared performance of different types of foreign banks (those whose operations were not concentrated in Asia and others) and domestic banks during the Asian crisis. They found that foreign banks had relatively low non-performing loans and relatively high profitability and capitalization, and these indicators even improved during the crisis. The domestic banks had a large concentration of loans in the property sector and the share-purchase business, where most of the losses occurred during the crisis. Contrary to popular belief, foreign banks did not abandon the Malaysian market during the crisis; on the contrary, their lending and deposits contracted less than domestic banks, perhaps because depositors perceived them as safer and switched their deposits to them.
- *Korea*: While still too early to draw any definite conclusions, the experience of Korea tends to support the view that the overall financial conditions and performance of foreign bank branches is stronger than those of domestic banks. In addition, it seems most likely that greater foreign bank participation contributed to increased banking competition, as evidenced by the reduced non-interest income from the trading of foreign currency and derivatives, and thereby to reduced profits.
- *Central and Eastern Europe*: The experience in the economies of Central and Eastern Europe is that growing foreign involvement has been instrumental in aligning the financial systems of emerging market economies in these regions more closely with international standards in terms of capital allocation, risk management and corporate governance. Countries in Central and Eastern Europe became major recipients of financial sector FDI when the privatization of their banking systems and preparations for EU membership took place in the second half of the 1990s. In some instances, the unsatisfactory results of early domestic privatization schemes led the authorities to rely on foreign resources to recapitalize their banking sector and permit foreign ownership (Poland and the Czech Republic).
- *Latin America*: The experience of Latin America with foreign banks is mixed. During the Argentina crisis, several international banks not only reconsidered their plans of expansion, but also considered reducing their presence in the region. The Argentine experience is often cited as an example of the so-called "cut and run" hypothesis, namely that foreign banks tend to leave the banking sector when faced with difficulties. The experience of Uruguay is different, however. Here, foreign banks were supportive of the package of measures that the authorities put in place, which helped to avoid a full-blown banking crisis. Thus the Latin America experience shows is that even during a crisis, the behavior of foreign banks with regard to supporting subsidiaries or branches depends on the actions of local authorities.

IV. CONCLUSIONS

The recent wave of foreign investment in China's banks and the prospects of further opening of the banking sector under the WTO agreement constitute a distinct element in the ongoing process of banking sector reform in China and suggest that, going forward, foreign banks are likely to play an increasingly important role in the Chinese banking system. This paper takes stock of the involvement of foreign banks in the Chinese banking sector in light of international experience.

While in most other countries foreign bank entry took the form of direct takeover or majority shareholding, foreign investments in China's banks have been minority shareholdings with very limited management involvement mainly because current rules restrict foreign ownership to relatively small minority shares. The investments are strategic from the foreign banks' point of view, as a way to enter the Chinese market, but so far they have been only important portfolio investors in the Chinese banks, with some side activities.

Overall, China appears to be well positioned to benefit from further opening of the banking sector to foreign investors. The main lesson of international experience is that foreign banks can bring important benefits if appropriate incentives and sufficient opportunities are created. Creating such incentives and opportunities for foreign investors would help so that the financial system can reap the potential benefits of greater foreign participation and foreign investors can bear the full risks and rewards of lending decisions made by these banks. The entry of major foreign banks as minority investors in Chinese banks is a relatively recent event and the full opening of banking services to foreign competition is an ongoing process. Therefore, some time will be needed before a more definite experience with the role of foreign banks in China can be identified. Future research could usefully focus on the impact foreign investors have had on the core operations of Chinese banks, the effective degree of opening of the banking sector in different product lines and regions, as well as the impact potentially greater foreign bank presence may have on banking market conditions and efficiency.

Table 1. China: Foreign Investors in the Five Largest Banks

Bank (estimated assets, end-2005)	Foreign Investor	Board Representation and Management Responsibility	Technical Assistance	Investment Safeguards, Specific Cooperation	Listing Status
Industrial and Commercial Bank of China (\$827 billion).	Goldman Sachs, Allianz, and American Express , 8.5 percent (combined) for \$3.8 billion (of which Goldman Sachs \$2.58 billion).	Goldman Sachs to nominate one Board member, no management responsibility.	Risk management, corporate and investment banking, credit cards (Amex), and insurance (Allianz).	Compensation only if book value declines below end-2005 level prior to the IPO.	IPO in Hong Kong and Shanghai in October 2006, raised almost \$22 billion.
Agricultural Bank of China (\$608 billion).	None	--	--	--	--
Bank of China (\$587 billion).	Consortium led by the Royal Bank of Scotland , 9.6 percent for \$3.0 billion (all data pre- IPO). UBS , 1.6 percent for \$492 million. Temasek , 4.8 percent for \$1.5 billion	RBS to nominate one Board member, no management responsibility. None None	Corporate governance, risk management, and IT. Cooperation with RBS in wealth management, credit cards, and corporate banking; partnership with UBS in investment banking and securities.	Compensation if book value through end-2007 declines below book value at end-2004. Credit cards: 50:50 management of a business unit with RBS, when a separate joint venture is established, RBS will have 49 percent ownership.	Raised \$11.2 billion in Hong Kong and started trading on June 1, 2006.
China Construction Bank (\$568 billion).	Bank of America , 8.5 percent for \$3 billion. Temasek 6.0 percent for \$2.5 billion.	One Board member and no management responsibility. Could nominate one Board member, but no plans to do so now; no management responsibility.	Approximately 50 personnel to assist in risk management, governance, consumer banking, and other areas. 1000 person/day training in treasury business and other areas.	An adjustment of the purchase price if December 2004 financial statements are restated; credit card venture under negotiation. No known adjustment.	IPO in Hong Kong, started trading on October 27, 2005. Total funds raised \$9.2 billion.
Bank of Communications (\$176 billion).	HSBC , 19.9 percent for \$1.75 billion.	Two Board members, one on audit committee, the other on personnel and compensation committee. One senior manager (vice president) and management of the credit card business.	At least 150 hours of technical assistance each year, eight HSBC experts are working in BoComm now, three more to arrive in 2006.	Credit card business unit set up, with 50:50 representation of BoComm and HSBC managers, to be converted to a Sino- foreign joint venture with 50:50 shares.	IPO in Hong Kong in June 2005, raising \$2.16 billion.

Table 2. Foreign Investors in Smaller Banks

Bank	Foreign investor
JOINT-STOCK COMMERCIAL BANKS 1/	
Shanghai Pudong Development Bank	Citigroup , 4.6 percent for \$72.5 million. An increase to 19.99 percent was agreed by shareholders in Feb 2006.
China Minsheng Banking Corporation	IFC , 1.1 percent at \$23.5 million. Temasek , 4.6 percent for \$100 million
Shenzhen Development Bank	Newbridge , 17.9 percent, at \$149.2 million General Electric (GE) , 7.3 percent share, for \$100 million
Huaxia Bank	Deutsche Bank , 9.9 percent [April 2006: may increase holding to 20 percent] Sal. Oppenheim Jr. , 4.1 percent
Industrial Bank of Fujian	Hang Seng Bank , 16 percent at \$208 million IFC , 4 percent at \$52 million GIC , 5 percent at \$65 million
Guangdong Development Bank	Citigroup-led consortium , approximately 85 percent for \$3.1 billion
Evergrowing Bank	Standard Chartered , 15 percent
Bohai Bank	Standard Chartered , 19.9 percent at \$123 million
CITY COMMERCIAL BANKS 2/	
Bank of Shanghai	HSBC , 8 percent for \$62.6 million IFC , 7 percent for \$50.3 million Shanghai Commercial Bank , 3 percent for \$21.6 million
Bank of Beijing	ING Groep NV , 19.9 percent at \$215 million IFC , 5 percent for \$54 million
Dalian City Commercial Bank	SHK Financial , 10 percent at \$19.3 million
Hangzhou City Commercial Bank	Commonwealth Bank of Australia , 19.9 percent at \$78 million
Jinan City Commercial Bank	Commonwealth Bank of Australia , 11.0 percent at \$17.3 million
Nanjing City Commercial Bank	IFC , 15 percent for \$20 million BNP Paribas , 19.2 percent
Xian City Commercial Bank	Bank of Nova Scotia , 12.5 percent at \$20.2 million IFC , 12.4 percent at \$20.0 million

Sources: People's Bank of China, HSBC Equity Research, OECD, news reports, and listing information.

1/ Joint-stock commercial banks have nation-wide license, but their branch networks are usually confined to the region where they originated. Mostly owned by state-owned enterprises and local governments. Not listed in this table, for the lack of information about any strategic investor, are CITIC Industrial Bank, China Everbright Bank, China Merchants Bank, and China Zheshang Bank.

2/ City commercial banks have been created by mergers of urban credit cooperatives and their business is restricted to local customers. There were 112 city commercial banks at end-2004.

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