Foreign Investment in Chinese Joint Stock Banks: 1996-2006

Kodjo Abotsi

Fudan University, China

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Kodjo Abotsi, Master Degree Candidate, Finance
Fudan University, School of Economics

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Introduction

The accession of China to the WTO in 2001 has opened up new routes for foreign investors in China. Regulations and restrictions are progressively eased or lifted, and foreign institutions have been progressively allowed to play an increased role in the Chinese economy.

The banking sector has been one the most affected by changes in the economy. For years China has been embarking on a reform of its banking industry, which has gone from a one-bank system to a more decentralized one, with the People Bank of China playing the role of the Central Bank, policy banks, four state-owned banks, which control most of the commercial banking sector, medium-sized joint stock banks, and more than a hundred city banks.

Foreign banks have been allowed to re-enter the Chinese banking system in the 90s, through opening of branches or representative offices, or by acquiring shares of local Chinese bank. Though ownership restrictions applied, foreign banks and financial institutions have been rather bullish on investing in China, due to the high expectations on the opportunities in the country post-WTO financial sector.

This article will review the foreign investment in China joint stock banks and analyze the motivations behind these investments. We will start by reviewing the comparative advantage of local joint stock banks as foreign investment recipients, as compared to larger state-owned commercial banks or smaller cities banks; we will then study the effects on efficiency and overall performance of minority foreign investment in joint stock banks in China. Finally, we will try to identify the opportunities that will beneficiate joint stock banks in China after liberalization in 2007, and how foreign banks can make the most of it.

Although some of the large state owned banks have constituted themselves into shareholding banks, or have created joint-stock arms in their process of their restructuration and preparation for international public offering, they will not be considered in our paper. On the other hands, as far as foreign investors are concerned, our main focus will be on international banking institutions engaged in commercial or similar businesses in their home country or in the global scene, although we know that not all of the investors in the banking sector in China are in this group; indeed, some international non-banking institutions (such as the IFC and the ADB), governments investment funds (Singapore) or even insurance companies are very active in investing in banking in China, but will not be the focus of this research.

This paper is an outline of our upcoming final thesis, for more in-depth analysis and data please refer to the latter document.

Comparative advantage of joint stock banks as foreign investment recipients in China

Medium-size joint stock banks, also named shareholding banks are one of the four groups of banking institutions in China. The others are:

-The State-Owned Commercial Banks, commonly named the "Big Four", which consist of Bank of China, the Industrial and Commercial Bank of China, China Construction Bank and the Agricultural Bank of China.

-The Cities banks:

-The Policy Banks:

Ten banks are considered joint stock commercial banks in China, with Bohai Bank joining the group only last year. This group includes both state-controlled shareholding banks (of smaller size than the Big Four) and private banks, with partial or complete local institutional investor ownership. These twelve banks are therefore the centerpiece of our study. They are:

-Minsheng Bank
-China Everbright Bank
-Huaxia Bank
-Citic Bank
-Bank of Communications
-Shanghai Pudong Development Bank
-Guangdong Development Bank
-Shenzhen Development Bank
-China Merchants Bank
-Industrial Bank (formally Fujian Industrial Bank)

Several factors explain the attractiveness of joint-stock commercial banks for foreign investors:

Pricing. Joint-stock commercial banks equity is usually more affordable to purchase. Investing one billion USD in one of the big Four will land less than 5% of total ownership. While with much less the foreign investor can have a larger part of a medium-size shareholding bank with national coverage. Although it is true that city banks equity is even cheaper to acquire, their geographic scope is much more limited, which makes them less attractive for serious foreign investors.

Government weight. From an historical perspective, banks in China have had a rather heavy government say in their management. This is due to the fact that banks usually were more a tool of policy application than a true financial institution with profitability as primarily objective. Although some reforms have been made in the 1980s and 1990s, and have accelerated tremendously after the accession to the WTO, there are still areas where the government implication is still very important.

The government interests are not always aligned with the maximization of shareholders interests' principle that guides foreign investors. Largest state-owned banks are still under direct control of the central government or its institutions, while smaller cities banks are controlled by local governments. Foreign investors can more easily influence the institutional investors in the joint-stock commercial banks.

Corporate Governance. Chinese banks have been widely criticized for their lack of corporate governance; independent directors have appeared only recently and have not yet completely become part of the culture in the banks (and most state owned enterprises, by the way); the banks need to develop a culture of full disclosure, including in the accounting and finance areas; the information that are usually released by those banks fell short of international practices.
Because of their shorter history and the presence of private institutional investors, medium size joint stock banks can more easily adapt to these new standards. Although they are not completely immunized of government intervention, the lesser degree of this presence will give more possibilities for foreign investors to execute the much needed corporate governance reforms.

Risk Management. Risk management has been a blur concept in China until recently. The banks had to supply funds to SOEs based on the state policy and regardless of profitability or without the guarantee that those loans would be paid back. The joint stock banks, being much younger (most of them came into existence in the 1990s), are less exposed to this situation. The lower level of non performing assets are a direct result of this fact. When choosing joint stock banks as their investment target in China, foreign investors will be able to implement more easily their advanced risk management strategies in a more prepared environment, and therefore should achieve more noticeable results in the long term.

Control and Management. Currently, foreign parties are allowed to control up to 25% of a single bank, with a single institution limited to 20%. Such ownership structure means that foreign investors can only be minority shareholders in the local banks. The largest state owned commercial banks make over two third of the banking assets in China. From a long term economic stability point of view, and in order to ensure proper control and monitoring of the financial sector of the country, China needs to maintain a control over these institutions and under no circumstances would hand over a controlling part to foreign actors. We believe that will still be the case even after complete liberalization of the banking sector in 2007. Over the years, the foreign investors have found out that if they want their investment to turn into a controlling interest, they have no other choice than going to shareholding banks. By doing so, they will be facing less resistance both from the government financial watchdogs and the public opinion. There is no surprise therefore that some of them are planning to increase their ownership to 40% and beyond as soon the regulations allow to do so.

Asset Quality. Joint stock banks have lower Non Performing Loans compared to their peers the State Owned Banks or even the city banks. Moreover, their balance sheets are clearer and even before foreign entry, they have been more selective and prudent in terms of loans allocation to state owned firms. From the foreign banks point of view, it is easier to improve such banks because of their higher asset quality, and the fact that there are less chances to discover hidden losses or financial landmines.

Effects on efficiency and overall performance of minority foreign investment

Research indicate that in developing countries, foreign banks have proved to be the most efficient, followed by private domestic banks, and then by state-owned banks. This is due to the fact that foreign banks usually have a longer banking history, have improved over the years through stiff competition at their home markets and on the international level, and have assimilated in their operations the most advanced technology standards of the banking industry. On the other hand, private banks are more efficient that the state-owned banks due to the increased flexibility, lesser government intervention and objectives that are more aligned with shareholders interests.

The joint stock banks have appeared in China in the 1990s as a way of further diversification of the domestic banking industry. Although their particular background may differ, they retain some basic similarities:

-Smaller capitalization compared to the state-owned banks
-National coverage
-Presence of institutional investors (Minsheng Bank is the only bank with pure private ownership)

Over the years, joint stock banks have steadily improved in terms of assets size but also market share, mostly at the expense of state owned banks. They have done so through better answers to customer needs, specialization, and servicing in areas previously neglected by larger state owned banks, such as loans to Small and Medium Size Enterprises (SME).

How can foreign participation help improve the overall efficiency of Chinese joint stock banks and prepare them to the challenges of the twenty first century?

Acquiring shares of a joint stock bank will allow the foreign institution to have one or several seats on the board of directors of the bank, or even some managerial positions. Once this position secured, it would be easier to produce changes within the bank. Areas where foreign intervention can be beneficial to the joint stock bank are actually those areas that differentiate foreign banks of the domestic ones:

Superior managerial expertise and experience. Banking in China has been a closed industry for decades. Although we have seen significant changes since the early 1990s, adoption of advanced technology and introduction of new banking products and services, the level of local knowledge of the banking standards pale in comparison to their foreign peers. Areas such as customer service and innovation will need more work to be done. By bringing foreign experts from the foreign bank, joint stock banks have the ability to start changes from the top, and enable themselves to conceive plans that will eventually reflect upon the overall efficiency of their institutions. The joint stock bank may also have the opportunity to send some of its staff to the headquarters of the foreign partners to receive a more advanced training, which will help improve its overall efficiency.

Easier access to international capital markets. Joint stock banks have historically lower non performing loans compared to the Big Four, they have enjoyed higher profitability over the last decade and their capital adequacy ratio is more than acceptable. Nevertheless, their access to the international capital markets have been rather limited, and cooperation with a foreign institution will definitely allow them to speed up their integration in these global markets, both for funding and investment, especially when the regulations will permit more international operations. Having a well-known financial institution as shareholder have helped banks improve overseas investors confidence and smoothen public offerings in international stock exchanges.

Advanced banking technologies. When markets are completely liberalized, technology will become one of the primary factors to build an edge over competition. ATMs, online banking and security features are examples of areas where technology is called to play an important role. Access to such technologies will be made easier through partnership with foreign institutions.

Ability to diversify risks. Risk management has always been one of the grey areas of the Chinese banking sector. Few banking products other than the traditional deposit taking/loan making scheme have made some banks potentially vulnerable to an eventual default of large state-owned enterprises, and most of the NPLs that are being dealt with in recent years are related to the lack of effective risk management. With the entry of foreign investors, the banks will move with more determination to a higher control of the risks, through further monitoring of loans and expenses, and diversification of products and sources of revenues.

Opportunities for Chinese joint stock banks after sector opening

When the further opening of the banking sector takes place in 2007, and the restrictions for foreign banks are waived, the Joint Stock banks, together with the state owned banks, will become more vulnerable to those foreign financial institutions. Indeed, although at this point we do not possess complete information of the extent of this opening, foreign banks will more certainly have the opportunities to open more branches at a faster pace, and will be able to compete in areas that were restricted to domestic banks such as RMB services to individuals and credit card issuing. They will probably be able to increase their current ownership in domestic banks.

Joint stock banks will probably become hot targets for foreign acquisition or increased ownership of current overseas shareholders, due to the following factors:

-Establishing a national coverage by opening branches all over China can be very cost-prohibitive and slow even if the regulations allow doing so. Foreign investors will be enticed to acquire shares of existing banks, to avoid expansion costs and related expenditures, including marketing. State-owned banks will be too expensive to acquire, and cities banks are too small in size and geographically limited.

-National pride will prevent the largest state owned banks to be in “the hands” of foreigners. Public opinion would be less sensitive to foreign investors taking a majority control of joint stock banks.

A last point, that is worth reviewing, in the link between the stockmarkets and the banking industry. Although stockmarkets have been around for more than ten years now in China, banks have usually played a much important role in the Chinese economy as a source of funds for companies or for the financing of public projects. Only a handful of companies, most of them larger state owned enterprises, have access to the domestic capital markets. Although we have seen a surge in the stocks indexes in the last year or so, investor confidence in the stockmarkets have been historically low, considered the almost inexistent fiduciary duty of the firms listed on the Shanghai and Shenzhen stock exchanges; listing on domestic exchanges have been mostly considered as a way of gathering funds for re-investment in "hot" sectors such as real estate or other unrelated industry, instead of expansion of capacity or restructuration with the investor interests in mind.

As stockmarkets are undergoing tremendous reforms, and poised to become more efficient in the future, they will become a true alternative to bank funding for private enterprises, and for the average citizen, another opportunity to invest personal savings for more profit. This may be a setback for traditional banks, although the growing size of the country financial assets should compensate much of it. But we believe that once again joint stock banks will be more flexible to react positively to the changing environment. This will be the subject of one of our future papers.

Conclusion

Tremendous changes have happened in the banking industry within the five years span between the accession of the country to the WTO and the promised liberalization of its financial services. The Chinese government has made noticeable efforts both in terms of improving the general banking environment in China, and permitting foreign entry to the sector. Chinese banks have faced the trade-off between relinquishing part of the ownership and the lures of better operational performance, enhanced global reputation and injection of equity capital, which are brought by foreign institutional investors. On the other hands, foreign banks and financial institutions are faced with their own dilemma, investing their way into a fast-growing financial industry in China and established Chinese banks, with the marketing advantages that come along, while having to cope with the less brilliant reality of low asset quality, weak corporate governance, poor risk management and strictly control legal and regulatory environment.

In any case, banking in China is entering into a new era. Foreign banks, by investing into joint stock banks in China, have the opportunity to have their own share of the market, with the legitimate prospects of handsome profits unless any financial crisis or serious disturbance. The Chinese economy is poised to continue to grow at around 10% over the coming years, and with the complete liberalization of the financial industry, the banking industry will play an even more active role in that growth.

Investing in Chinese banks, especially joint stock banks will make sense even after complete market liberalization. For foreign banks, that will have the opportunity to create their own subsidiaries in China or expand the scope of existing ones, they will find it more cost-effective in the short-term to serve higher segments of the markets, especially those located in costal or larger cities, while pursuing market share and penetration through their ventures with local banks.

Kodjo ABOTSI, Master Degree Candidate
Fudan University School of Economics
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Email: abotsi@gmail.com

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Table: Foreign Investment in Joint Stock Banks in China: 1996-2006

Target Bank	Foreign Investor	Stake	Investment value (mil. USD)	Year
Shanghai Pudong Dev. Bank	Citigroup	5%	$73	2003
Industrial Bank	Hang Seng Bank	15.98%	$208	2003
	IFC	4.0%	$52.2	2003
	GIC	5.0%	$65	2003
Minsheng Bank	Temasek	4.55%	$106	2004
	IFC	1.2%	$23.5	2004
Bank of Communications	HSBC	19.9%	$1,747	2004
Shenzhen Development Bank	Newbridge Capital	19.9%	$149	2004
Bohai Bank	Standard Chartered	19.9%	$120	2005
Huaxia Bank	Oppenheim Sal	4.5%	$104.1	2006
	Deutsche Bank	9.5%	$220	2006
Guangdong Dev. Bank	Citigroup[1]	20%	$724	2006
	IBM	4.74%	$172	2006
China Everbright Bank	Standard Chartered	n/a	n/a	Pending

(1) Deutsche Bank AG purchased 295,000,000 shares (7.02%) and Deutsche Bank Luxembourg S.A. 121,000,000 shares (2.88%)

[1] The Citigroup-led consortium acquired 85.6% equity stake of the Guangdong Development Bank