Asia Focus

COUNTRY ANALYSIS UNIT FEDERAL RESERVE BANK OF SAN FRANCISCO JULY 2005

FOREIGN BANKS' NEW CHINA STRATEGY

After watching China's foreign direct investment boom pass them by most of the past decade, overseas banks have adopted a newly aggressive stance in the mainland market. Long-established players are expanding operations, new entrants have staked out sizeable positions, and novel expansion strategies are giving access to markets previously off-limits to foreigners. Bank investment remains a small part of total foreign direct investment, but growth is rapid. For the first time, foreign institutions appear set to play an important role in China's banking industry.

WATERSHED YEAR

The soaring value of recent investments marks the past eighteen months as a watershed for foreign banks in China. From 2001 through 2003, foreign banks bought shares in domestically-registered Chinese banks worth only $343 million. Since the start of 2004, deals completed and announced would raise foreign bank stakes in local institutions by $5.2 billion, or more than fifteen times the existing stock of investment. Paid-in capital of foreign bank branches and joint ventures, counted separately from investment in domestically-registered banks, rose 31% last year, after increasing only 2% in 2003. Foreign banks' direct control of system assets remained low at 1.8% last year, but the share is up 44% from 2003's 1.25%.

BIGGER ACQUISITIONS

Acquisition sizes are increasing. Until 2004, the biggest individual deal was Hang Seng Bank's $208 million purchase of 16% of Fuzhou-based Industrial Bank in 2003. Since then, ING has invested $215 million in Bank of Beijing, HSBC bought a 19.9% stake in Bank of Communications for $1.7 billion and Bank of America (BofA) announced its intention to pay $3 billion for approximately 9% of China Construction Bank (CCB). BofA has an option to take its stake in CCB, China's second-biggest bank by domestic assets, up to 19.9%. Press reports describe ongoing negotiations for similarly sized sales to foreign interests of two of the remaining Big Four banks, Bank of China and Industrial & Commercial Bank of China.

NEW STRATEGY

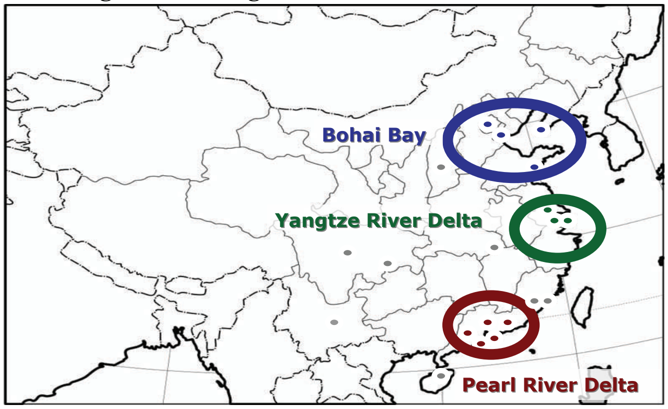
Acquisitions are changing the nature and geographic scope of the foreign bank presence in China. Before 2004, foreign banks operated almost exclusively through directly controlled branches and representative offices. Restricted by regulation to opening one branch per year, foreign banks focused on wholesale banking and trade finance in China's three top manufacturing centers (Figure 2). Now, acquisitions are quickly increasing multinational banks' exposure to retail banking, and access to extensive branch networks will allow foreign banks to cross-sell credit cards, insurance and mutual funds to a broad market. BofA's CCB deal immediately gives it a stake in the country's third-largest branch network. Bank of Communications provides HSBC with access to branches in 137 cities. On their own, foreign banks would need years to develop branch networks this big.

Figure 1: Foreign Bank Purchases of Stakes in Domestic Chinese Banks

Target bank	*Acquiring bank*	*Stake*	*Investment $ millions*	*Year*
Bank of Shanghai	HSBC	8.0%	$63	2001
Shanghai Pudong Development Bank	Citigroup	5.0%	$73	2003
Industrial Bank	Hang Seng Bank	16.0%	$208	2003
Bank of Communications	HSBC	19.9%	$1,747	2004
Xian City Commercial Bank	Bank of Nova Scotia	2.5%	$3	2004
Jinan City Commercial Bank	Commonwealth Bank of Australia	11.0%	$17	2005
Bohai Bank	Standard Chartered	19.9%	$120	2005
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	19.9%	$76	2005
Bank of Beijing	ING	19.9%	$215	2005
China Construction Bank	Bank of America	9.1%	$3,000	Pending
Nanchong Commercial Bank	Deutsche Investitions und Entwicklungsgesellschaft	13.0%	$4.8	Pending

Source: Collected from press releases

Figure 2: Foreign Bank Branches in China



RETAIL BANKING GROWING FAST

A desire to tap the retail market is driving many foreign banks' expansion plans. Consumer lending grew 41% on a compound annual basis the past four years, yet consumer loans still accounted for only 11% of banking system assets at the end of last year. As in much of the rest of Asia, consumer lending falls far short of developed country benchmarks (Figure 3). The potential for future expansion remains great.

Figure 3: Consumer Finance in China vs. U.S.

as of 12/31/2002	In $ billions		In % of GDP	
	China	U.S.	China	U.S.
Residential Mortgages	99.9	5,953.1	7.8	56.8
Consumer Credit	29.8	1,938.1	2.3	18.5
Retail Credit	129.7	7,891.2	10.2	75.2

Source: People's Bank of China and Federal Reserve

TOOL OF REFORM

The authorities envision an important role for foreigners in China's bank system reform. Domestic banks suffer from high non-performing loans, weak credit extension procedures and inadequate risk management systems. Regulators hope that foreign investors can improve corporate governance at domestic banks, and inject management expertise and recapitalization funds. Beijing's eagerness to reform the banking sector explains in large part the boom in foreign bank investment. Previously, foreign purchase of domestic bank stakes required approval of China's ruling body, the State Council, but the government updated guidelines in December 2003 to encourage foreign share purchases. Under the new rules, foreigners can own up to 25% of a domestic bank, with any single investor allowed up to 20%, dependent on regulatory approval.

INFLUENCE AND CONTROL

Despite their rapid inroads into the sector, foreign banks investing in domestic Chinese banks might find it hard to exert influence over management. Only Newbridge Capital, a U.S. non-bank investor holding 17.9% of Shenzhen Development Bank, maintains a controlling interest in a domestically-registered Chinese bank. Public entities control all other banks except China Minsheng Bank, which has only small foreign ownership. The authorities have declared that they intend to retain majority ownership of the Big Four banks indefinitely, and shareholding restrictions will limit foreign investors' influence over medium-sized and small banks. With fewer shares than the Ministry of Finance, HSBC lacks control of the Bank of Communications, and BofA's $3 billion investment buys it only one CCB board seat. The history of foreign investment in Chinese banks remains too short to assess its success in improving bank performance.

CHINA CONTRIBUTIONS STILL SMALL

Despite the increased interest in the mainland market, China investments will remain a small part of most foreign bank balance sheets for some time. BofA's planned $3 billion CCB investment represents only 0.2% of the U.S. bank's first quarter 2005 assets and 3% of shareholders equity. HSBC's Bank of Communications stake accounted for only 1.4% of its 2004 Asia-Pacific assets outside Hong Kong. BofA's proposed $35 billion merger with MNBA Corp. is valued at almost twelve times the CCB purchase, and HSBC's $15.9 billion acquisition of U.S.-based Household International in 2002 was worth nine times its Bank of Communications investment. Of the top investors in China, only two Hong Kong banks have placed a significant part of their balance sheets in China. Mid-sized Bank of East Asia had 16% of total loans booked on the mainland in 2004, and smaller Wing Hang Bank had 8%. Foreign banks have had much greater success penetrating Asian markets outside China. Foreigners control almost one-quarter of South Korea's bank assets, seven of the larger local Indonesian banks and three small and mid-sized Thai banks. Overseas banks face no significant restrictions in Hong Kong. Though big and growing, the Chinese market still matters less for multinational bank operations than a number of other countries and regions.

GROWTH OPPORTUNITIES

But foreign banks will find ample opportunity to continue expanding in China. As part of its accession to the WTO, China has pledged to allow foreign banks to offer full local currency services and open an unlimited number of branches starting in December 2006. Only CCB of the Big Four has sold a stake to foreigners. The government hopes to find foreign strategic investors for the remaining three. Regulators are considering raising foreign ownership limits for domestic banks, and if the Newbridge-Shenzhen Development Bank experiment succeeds, the authorities might allow foreigners to take management control of other small and medium-sized banks. Given the size of the planned Big Four sales and foreigners' eagerness to exploit the 2006 WTO liberalization, foreign bank investment in China over the next 1-2 years looks set to dwarf even the past twelve months' record-setting levels.

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