

CHINA'S BANKING INDUSTRY

JOSE CARLOS VALER DAVILA

- 1 IN 10 YEARS TIME, WILL THE CHINESE MARKET IN THE CHOSEN INDUSTRY BE DOMINATED BY DOMESTIC CHINESE FIRMS OR MULTINATIONAL FIRMS?
- 2 WHAT WILL BE THE IMPLICATIONS FOR GLOBAL MARKETS?

CONTENTS

1	In 10 years time, will the Chinese market in the chosen industry be dominated by domestic Chinese firms or multinational firms?	3
1.1	An analysis of the future competitive environment in the chosen industry in China.....	4
1.1.1	Brief review of the history of China’s banking system.....	4
1.1.2	Current China’s banking industry.....	8
1.1.3	China’s banking industry market environment: regulators.....	8
1.1.4	China’s banking industry market environment: competitors.....	9
1.1.5	China’s banking industry market environment: customers and suppliers	11
1.2	Trends in both the international and Chinese market environment and their implication for the future.....	18
1.2.1	Trends in Chinese market Environment	18
1.2.2	Trends in the international banking market environment.....	23
1.3	Analysis of the extent to which the Chinese market is unique or different to most other developed markets...25	
1.3.1	Immature financial market and young banking industry	25
1.3.2	The large overhang of shares owned by government entities	26
1.3.3	Labour market: Lack of professionals.....	27
1.3.4	Lack of development of more Financial Products and Markets	27
1.3.5	Inefficient finance allocation: financial intermediation monopoly and capital controls	27
1.4	an analysis of whether Chinese firms can compete with multinational firms in their home market.	32
1.4.1	Analysis of “CAGE distances” in China’s banking industry	33
1.5	on the advantages of multinational banks in china	35
1.5.2	“Adapt”. not to build a brand but to buy thorough china’s mechanisms	37
1.5.3	Avoid: using alternative mechanism to enter china banking industry.....	38
2	What will be the implications for global markets?.....	40
2.1	Scenarios to consider.....	40
2.2	Globalize for ADDING volume: where?	41
2.3	Current global status of China’s banks.....	42
2.4	Advantages/disadvantages of China’s banks going global in emerging markets	43
2.5	Advantages/disadvantages of going global in developed markets.....	43
	Bibliography	44

3 IN 10 YEARS TIME, WILL THE CHINESE MARKET IN THE CHOSEN INDUSTRY BE DOMINATED BY DOMESTIC CHINESE FIRMS OR MULTINATIONAL FIRMS?

The present report will show that in 10 years time, China's banking industry would still be dominated by Chinese firms. Analysing the future competitive environment in China's banking industry, we can see from the different sources that the non-market environment (mainly governmental policy) will drive the trends of the future (see p.18). Thus, only if the government continues to open industries, like banking, to foreign investment (see p.20), will we see an increase from the current 2% market share of multinational banks. In that scenario, Chinese banks could suffer pricing pressure and lower profitability, as seen in China's banking value chain (see p. 11).

For a better understanding of the issue, this report presents an overview of China's banking industry (brief history, current status of its value chain) and then it highlights trends in both the international and Chinese market environment using scenarios that, as we will see, depend mostly on economic development and stability. The uniqueness of China's banking industry arises from the institutional voids (immature financial market, poor regulation, large ownerships by government entities, lack of trained professionals, limited financial markets and products, and an inefficient finance allocation due to virtual intermediation monopoly and the capital controls).

In order to evaluate if Chinese firms are able to compete with foreign firms in the domestic market (see p.32), I find that the CAGE distances (comparing with the banks in the Asian regions and worldwide averages) are the main obstacles to be overcome by multinational firms. However, multinational banks have the advantage of a more developed financial knowledge that could allow them to ARBITRAGE the immaturity of China's fee-based business, to ADAPT, not by buying but by investing in the listed shares, or to AVOID the rules by listing foreign banks (dual listing, depositary receipts or A-H share classes), as an HSBC example will show.

Finally, I must state that preparing this report has been particularly difficult because of the institutional void of information. For instance, "the numbers say Chinese Banks are doing brilliantly" but the market doubts the veracity of the numbers given the institutional void of poor information and regulation (The economist, 2011).

3.1 AN ANALYSIS OF THE FUTURE COMPETITIVE ENVIRONMENT IN THE CHOSEN INDUSTRY IN CHINA

In this section I give an overview of China's banking industry, a brief review of its history, focusing not only on the formal banking system but also in the financing channels of other firms that include non-bank channels.

3.1.1 BRIEF REVIEW OF THE HISTORY OF CHINA'S BANKING SYSTEM

In this section, I will provide a brief history of China's banking industry through a review divided in stages extracted and adapted from recent studies (Allen et al., 2005; Werner & Chung, 2010):

- From the initial forms of banking in China in the 17th century until 1949
- The banking system during the centrally planned economy from 1949 to 1978
- The first reform period from 1978 to 1984
- The second reform period from 1984 to 1994
- The third (present) reform from 1994

According to (Werner & Chung, 2010) it can be asserted that the Chinese banking system "has undergone a significant amount of reform over the past three decades..." and that "...the pace of reform has been slow when compared with other industries, especially the industrial and manufacturing-based sectors."

3.1.1.1 BACKGROUND: FROM THE 17TH CENTURY UNTIL 1949:

The history of China's banking industry can be dated back to the late Ming Dynasty (17th century). According to a study (Allen et al., 2005):

"...with commerce initiated in the Zhejiang-Jiangsu area and further developed during the Qing Dynasty (17th century to early 20th century). The Opium War (1840s) between China and Great Britain ruined China's sovereignty, but it brought Western-style legal and capital systems into China's coastal areas (until 1949) (...) The development of China's financial system from the late nineteenth century to the early twentieth century was highlighted by the emergence of Shanghai as the financial center of China and Asia (...)." (pp.5-6)

3.1.1.2 BANKING IN A CENTRALLY PLANNED ECONOMY. FROM 1949 TO 1978:

The modern period initiates with the revolution and centrally planned economy. According to a study (Allen et al., 2005):

After the foundation of the People's Republic of China in 1949, all of the pre-1949 capitalist companies and institutions were nationalized by 1950. Between 1950 and 1978, China's financial system consisted of a single bank -- the People's Bank of China (PBOC), a central government owned and controlled bank under the Ministry of Finance, which served as both the central bank and a commercial bank, controlling about 93% of the total financial assets of the country and handling almost all financial transactions. (p.6)

3.1.1.3 BANKING IN THE REFORMED SOCIALISM. FIRST REFORM PERIOD 1978-1984:

The first main structural change began in 1978 and ended in 1984 when the State-Owned Commercial Banks were created and the Central Bank was established, according to a (Werner & Chung, 2010):

Under the leadership of Deng Xiaoping (...) began to institute economic reforms (...) this marked the start of a gradual shift from a centrally planned economy where the prices and quantity of goods produced were determined by the State to a socialist market economy that is more responsive to market dynamics. (...) these reforms have been enormously successful, resulting in three decades of 10% compound annual real GDP growth, a significant drop in China's poverty level, a structural shift in the country from an agrarian economy to an industrial & exporting (mercantilist) one, and a marked improvement in China's geopolitical and financial standing in the world arena. (p.5)

3.1.1.4 SECOND REFORM PERIOD 1984-1994

After 1984 until 1994 the evidence shows that although China's banking system began to grow and to open up to new competitors, it was still heavily influenced by the government and lacked a proper legal and regulatory scheme. According to (Allen et al., 2005):

For most of the 1980s, the development of the financial system can be characterized by the fast growth of financial intermediaries outside of the "Big Four" state-owned banks (...). For example, regional banks (partially owned by local governments) were formed in the Special Economic Zones in the coastal areas; in rural sectors, a network of Rural Credit Cooperatives (RCCs; similar to credit unions in the U.S.) was setup under the supervision of the ABC, while Urban Credit Cooperatives (UCCs), counterparts of the RCCs in the urban areas, were also set up. Non-bank financial intermediaries, such as the Trust and Investment Corporations (TICs; operating in selected banking services and non-banking services with restrictions on both the sources of deposits and loans made), emerged and proliferated in this period. (...) (pp.7-8)

Despite the lack of regulation and the influence of the government, the four state banks showed great dynamism, according to (Werner & Chung, 2010):

While their main policy directives were handed down by The State, the four state-owned commercial banks (BOC, China Construction Bank [CCB], ICBC and Agricultural Bank of China [ABOC]) were given some latitude to grow their commercial banking operations. In order to promote their commercial banking businesses, these firms dramatically expanded their deposit-taking branch networks. While good data are difficult to obtain for this period of banking reform in China, we do know that the CCB more than quadrupled its branch network (from 4,000 to 20,000) and employee base (57,000 to 250,000) between 1985 and 1992. (p. 7)

In addition, other forms of finance vehicles appeared. According to (Werner & Chung, 2010), "...the Chinese government allowed several joint-stock commercial banks and rural and urban credit cooperatives to be established." (p. 7)

3.1.1.5 THIRD REFORM PERIOD 1994 TO CURRENT

The Deng Xiaoping's "Southern Tour" of 1992 "marked the beginning of another economic boom" (Allen et al., 2005) that spanned to the financial system through a deregulation process in the banking system and an openness in the capital markets with the establishment of China's stock exchanges:

In the financial system, this period witnessed a sharp increase in foreign direct investment (FDI), a deregulation of the banking sector characterized by the emergence of many new state/local government owned commercial banks, and the re-emergence of Shanghai as the financial center of China.(...) Along with the growth of banks and financial intermediaries, interbank lending (1994) and bond (1997) markets were established, and the bank debit/credit cards market expanded rapidly. (...) The interbank lending rates were converted toward a uniform system in 1996. (p. 8)

In addition, major reforms were made through the start of stock exchanges and the exchange rate policies. According to (Allen et al., 2005):

Two domestic stock exchanges, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE), were established in 1990 (...) However, the legal framework and institutions that support the stock market lag the growth of the exchanges. (p. 9)

Furthermore, the following reforms were established in China's banking system, according to (Werner & Chung, 2010), with the greatest impact caused the Commercial banking law:

...which clearly established the legal framework under which commercial banks in China could operate; laid out the termination and transfer of control process for an insolvent bank (or one facing a deposit run); determined the registration requirements to become a bank; and set out basic principles of operation and accounting standards. In addition, the law required that commercial banks be responsible for their own business operations, risk management and financial performances (rather than government authorities, either local or central) and mandated that the credit examination process be separated from the loan-granting process.

Despite the formal guidelines established in the Commercial Banking Law, the government still wielded a heavy influence on the operations of the commercial banks in China as the State Council maintained purview over credit allocated by the banks. (pp. 7-8)

3.1.1.6 CHINA'S BANKING INDUSTRY DURING THE ASIAN FINANCIAL CRISIS 1998-1999

It has been argued (Werner & Chung, 2010) that “China enjoyed relative immunity from the 1997-98 Asian Financial Crisis as its stringent regulations on cross-border capital flows prevented the build up and subsequent withdrawal of foreign capital from its banking and financial markets.”

Meanwhile, “China used this period of neighbouring economic weakness to enact reforms on many of its state-owned enterprises (SOEs),” (Werner & Chung, 2010), and even “following the Asian Financial Crisis in 1997, financial sector reform has focused on state-owned banks and especially the problem of NPLs (the China Banking Regulation Committee was also established to oversee the banking industry).” (Allen et al., 2005)

3.1.1.7 FIRST SET OF BANKING REFORMS: CHINA ENTERING THE WORLD TRADE ORGANIZATION (WTO) 2000-2003

Analysts (Allen et al., 2005) considered China's entry into the WTO (December 2001) as “the beginning of a new era”. They expected to see increasing competition from foreign financial institutions and frequent and large- scale capital flows.

Others (Werner & Chung, 2010) considered that “the WTO agreement stated that upon accession into the WTO, China would have to allow foreign financial institutions to provide foreign currency business to clients without restriction. Within two years of accession, the WTO stated that foreign financial institutions would have to be permitted to provide local currency business to Chinese enterprises and that within five years of accession, foreign institutions would be permitted to provide services to all Chinese clients.”

These reforms brought clarity through adopting international accounting standards or being listed on stock exchanges. According to (Werner & Chung, 2010):

As a result, the banking industry adopted international global accounting standards as well as shareholder and corporate governance reforms (despite being majority-owned by the government). In addition, as many banks chose to list on the Hong Kong Exchange (which applies more stringent listing standards than the two Chinese equity exchanges), the focus on credit and risk management was brought to the forefront for many of these firms, and some are even expanding into foreign markets. The path to public listing of the large commercial banks in China also resulted in an increase in the disclosure requirements and auditing standards. The result was the recognition of a large number of non-performing loans on many of the banks' balance sheets, the scale of which resulted in the banking system being inadequately capitalized. This necessitated a second government-sponsored wide restructuring of the banking system. (p. 10)

3.1.1.8 SECOND SET OF BANKING REFORMS 2003-2005

The need for capital adequacy and to be listed on the stock exchanges led to restructuring and successful IPOs of commercial banks, state-owned banks then followed the lead and after that western international financial institutions took a stake with consequent “significant capital gains,” according to (Werner & Chung, 2010).

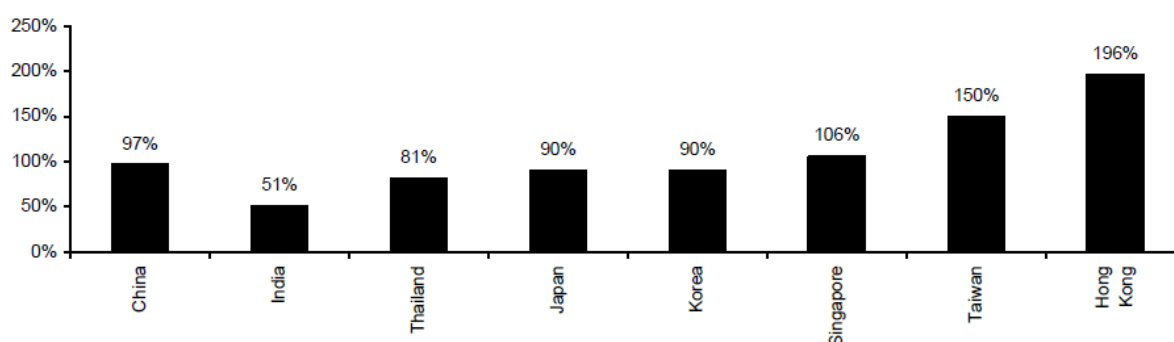
3.1.2 CURRENT CHINA'S BANKING INDUSTRY

China's banking system has grown considerably. In US dollar terms, the country's formal banking industry reached 14 thousand billion in assets (see Figure 1). In comparison with other countries, for instance, total loans outstanding as a percentage of nominal GDP reached 125% (Werner & Chung, 2010). This level is higher than most other Asian countries (see Figure 2).

Figure 1. Data of China's Banking industry in USD billions. Source: (Business Monitor International, 2011)

Date	Total assets	Client loans	Bond portfolio	Other	Liabilities and capital	Capital	Client deposits	Other
November 2009	11,626.9	6,172.3	1,342.7	4,111.9	11,626.9	331.8	8,883.0	2,412.1
November 2010	14,384.6	7,488.6	1,562.4	5,333.6	14,384.6	0.0	10,940.8	0.0
Change, %	24%	21%	16%	30%	24%	-100%	23%	-100%

Figure 2. Loans as percentage of nominal GDP. Source: (Werner & Chung, 2010)



3.1.3 CHINA'S BANKING INDUSTRY MARKET ENVIRONMENT: REGULATORS

China's banking industry has regulators and other institutions that attempt to fill the institutional voids in China that must be mentioned. According to (Business Monitor International, 2011):

Central Bank: People's Bank of China (PBC) www.pbc.gov.cn

The PBC was established in 1948, essentially as a state-owned commercial bank, and has functioned as a central bank since 1983. Under the guidance of the state council, the PBC formulates and implements monetary policy, prevents and resolves financial risks and safeguards financial stability.

Principal banking regulator: China Banking Regulatory Commission (CBRC) www.cbrc.gov.cn

The CBRC authorises, supervises and regulates banks in China. It seeks to protect depositors' and consumers' interests, maintain market confidence, boost the public's understanding of

modern finance and to fight financial crime. It also says it aims to ‘encourage fair and orderly competition’.

Banking trade association: China Banking Association (CBA) www.china-cba.net/eng/

The CBA was founded in May 2000 as a social organisation registered at the Ministry of Civil Affairs. On behalf of its 81 full members and 37 associate members, the CBA brings together various types of banking institution to represent the interests of this rapidly changing industry. (...) its missions (are:) self-regulation, rights protection, reconciliation and services. (p.36)

3.1.4 CHINA’S BANKING INDUSTRY MARKET ENVIRONMENT: COMPETITORS

The China’s banking industry is composed of several kinds of institutions that reveal the complexity of the environment. There are 81 full members of the China Banking Association. However, according to (Werner & Chung, 2010):

... there were more than 5,600 banking institutions operating in China, though a large majority (more than 5,200) of these institutions were small rural banking cooperatives (they garner a mere 8% of total banking assets in China). The number of financial institutions has decreased significantly over the three years from 2004-08 (from 33,800 to 5,600) as many of the smaller rural banks have been combined (in restructuring efforts to improve their efficiency) or closed (in the case of poorly managed or performing banks). The only other category of banks to see a significant reduction in the number of institutions during this time frame was the Urban Credit Cooperatives, whose numbers fell from 681 in 2004 to 22 in 2008, as these banking institutions were also restructured via either merger with each other or an acquisition by the city and JSCBs. (p.34)

China’s banks are grouped into the following categories:

Table 1. Definitions of Financial Intermediaries/Institutions in China

Institutions	Definition (Allen et al., 2005),	Banks (Business Monitor International, 2011)
State-owned Banks (Big four)	There are four 100% state owned banks, BOC, PCOC, ICBC, and ABC. They carry out commercial banking functions. However, they are heavily regulated and interfered with by the PBOC, such as the imposition on interest rate restrictions and loan allocations.	Industrial and Commercial Bank of China Agricultural Bank of China Bank of China China Construction Bank
Policy Banks	There are three policy banks in China, all created in 1996 and belonging to the Treasury department. They are the Development Bank of China, the Import and Export Bank of China, and the Agriculture Development Bank of China. These banks carry out policy financing roles. For example, issuing bonds or making loans for the development of specified projects or certain sector of the economy.	Export-Import Bank of China Agricultural Development Bank of China China Development Bank

Institutions	Definition (Allen et al., 2005),	Banks (Business Monitor International, 2011)
Other Commercial Banks	There is a variety of commercial banks in China with a variety of different types of ownership in addition to the four largest state-owned banks. They can be owned by central government, local government, communities, and individual persons or enterprises. They carry out the functions of commercial banks, and are heavily regulated by the PBOC, mainly on interest rates.	Joint-Stock Commercial Banks, City Commercial Banks And Rural Commercial Banks: Bank of Communications China Bohai Bank China CITIC Bank China Everbright Bank Huaxia Bank Guangdong Development Bank Shenzhen Development Bank China Merchants Bank Shanghai Pudong Development Bank Industrial Bank China Minsheng Banking Corporation Evergrowing Bank China Zheshang Bank Bank of Shanghai
Rural Credit Cooperative	A Credit Cooperative is a non-profit organization, providing financial services, such as lending and savings to its members. Rural Credit Cooperatives are owned and operated by communities in rural areas, and are widespread in China. They started in 1984, and were overseen by the Agriculture Bank of China until 1996. They were then regionally merged and overseen directly by the PBOC.	Bank of Beijing Baoshang Bank Tianjin City Commercial Bank Guangzhou Commercial Bank Shenzhen City Commercial Bank Chongqing Commercial Bank Chengdu City Commercial Bank Kunming City Commercial Bank Xian City Commercial Bank Lanzhou City Commercial Bank Nanjing City Commercial Bank Urumqi City Commercial Bank Beijing Rural Commercial Bank Corporation Shanghai Rural Commercial Bank
Urban Credit Cooperative (UCC)	This is the counterpart of the RCC in the city. In 1996, they were regionally merged and became called City Commercial Banks.	
Postal Savings	These are deposit-taking institutions run by the Bureau of Post Savings, and regulated by the PBOC. Local branch offices are affiliated with the post offices in the same area, and provide wire transfer, distribution of treasury bills, and also act as agencies for insurance or retirement funds.	
Asset Management Company	The four Asset Management Companies were set up in 1998 to help the financial restructuring of the four major state-owned banks'. They are specialized in managing and recovering the NPLs transferred from the four banks.	
Trust and Investment Company	In a TIC, a trustee accepts, manages, or uses the trust capital or trust properties in accordance with the special objectives or requests designed by the trust creator. It provides bank (custodial, payment, guarantees) and non-bank (security issuance, financial leasing) financial services. Its loan is restricted to "circulating funds", i.e., working capital (< 3 months). Its sources of funds include: government Treasuries, government departments that administer enterprises, labour protection and welfare institutions, research institutions, academic associations and other foundations.	
Non-deposit Financial Intermediaries (e.g., finance Companies)	By law, these companies cannot take deposits. They raise capital from organizations and investors and make loans to individuals or businesses.	
Mutual Fund	An open- or close- end fund operated by an investment company which raises money from shareholders and invests in a group of assets, in accordance with a stated set of objectives.	

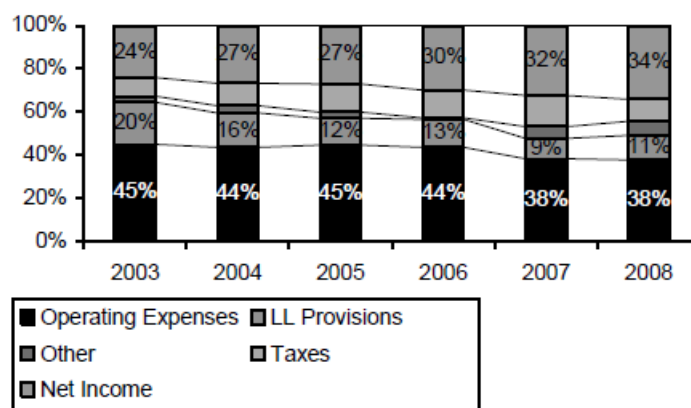
Institutions	Definition (Allen et al., 2005),	Banks (Business Monitor International, 2011)
Locally Registered Foreign Banks		HSBC Bank (China) Standard Chartered Bank (China) DBS Bank (China) Bank of East Asia (China) Bank of Tokyo-Mitsubishi UFJ (China) Mizuho Corporate Bank (China) Hang Seng Bank (China) First Sino Bank Xiamen International Bank ABN AMRO Bank (China)

3.1.5 CHINA'S BANKING INDUSTRY MARKET ENVIRONMENT: CUSTOMERS AND SUPPLIERS

In the banking value chain the customers and suppliers are constituted by the demand (loans) and supply (deposits) of money while the banks profit from managing the risks of liquidity and credit in the form of interest arbitrage (net interest income). In addition, banks provide services and generate income in the form of fees. When the risk management is incorrect, banks suffer losses mainly in the form of provisions for bad loans.

In the case of China's banks (see Figure 3), it can be seen that "while revenues grew at a 21% annual rate, operating expenses have grown by just 17% annually over 2003-08 and loan-loss provisions grew just 8%. As a result, net income for the banks we've examined has grown 30% per annum. Additionally, after-tax profit margins improved from 24% in 2003 to 34% in 2008." (Werner & Chung, 2010, p.18).

Figure 3. As a percentage of operating income – Five Large Chinese Banks. Source: (Werner & Chung, 2010)



In the next sections, I present an assessment of the China's banks key sources of income and losses, analyzing first the bottom-line through the traditional measures of profitability as follows:

- Profitability
- The different sources of revenue (and their weight in the structure):
 - Interest income: from corporate loans, retail banking and the nascent consumer lending.
 - Interest payed: deposits and liabilities
 - Fee-based businesses
- The critical source of losses: provisions for bad debts or net provisioned loans (NPL)

3.1.5.1 CURRENT PROFITABILITY OF CHINA'S BANKS

The components of China's banking industry value chain, according to a study (Werner & Chung, 2010), have caused over recent years (2004-2008) that Chinese banks enjoy a "strong revenue growth and improving profitability (...) driven by the improving credit quality of the banks' loan portfolios, strong loan growth (annual growth rates of approximately 15%) and the expansion of the banks' fee-based businesses." (p. 17)

Looking at the usual indicators of profitability for banks, ROE and ROA (see Figure 4 and Figure 5), according to (Werner & Chung, 2010):

(The indicators) show the significant increase in profitability for the entire group of banks over the 2004-08 time period, driven by the increase in net interest margins, the decrease in non-performing loans (which was partially helped by the government-financed restructurings in 2003-05), the increase in focus on shareholder profitability by the large SOCB and JSCB and the increase in fee-based revenue generation." (p.34)

Figure 4. ROA (After tax profits / Average assets. Source: (Werner & Chung, 2010)

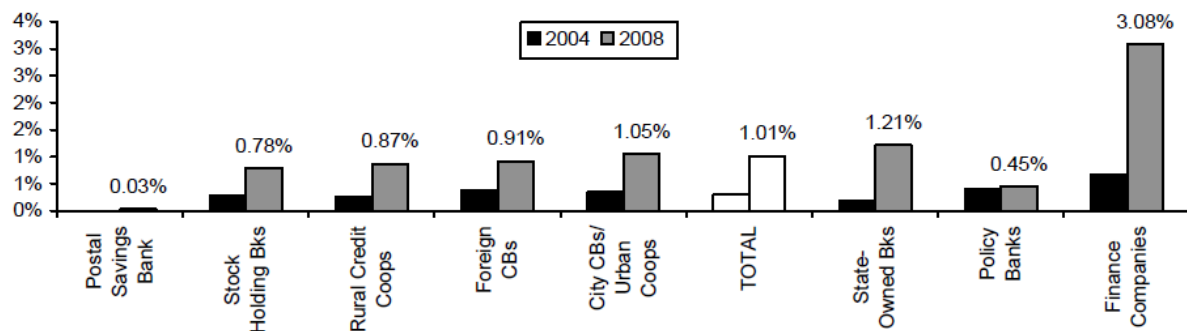
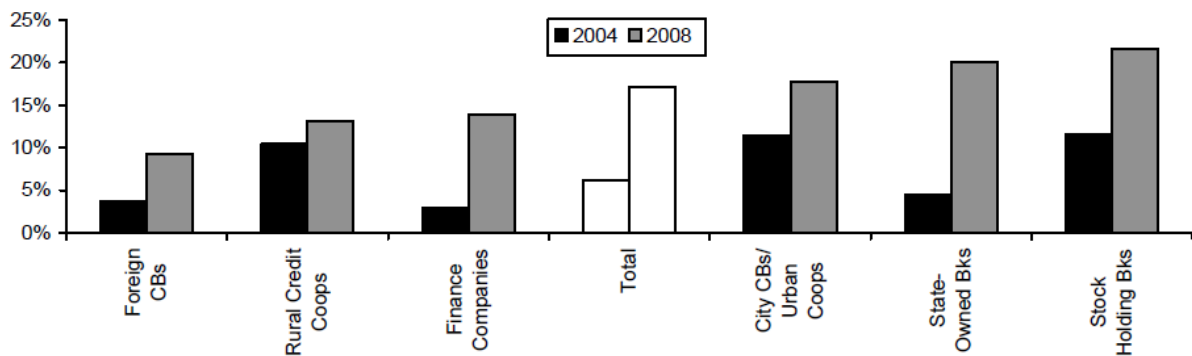


Figure 5. ROE= After tax-profits/Average equity. Source: (Werner & Chung, 2010)



3.1.5.2 STRUCTURE OF INCOME IN CHINA'S BANKS:

The composition of the sources of income is difficult to assess as "China does not publish aggregate income statement data for the banking industry" (Werner & Chung, 2010). However, studies (Werner & Chung, 2010) could infer from the available information that:

The bulk of the revenues generated at the Chinese banks comes in the form of net interest income, sourced from their traditional commercial banking activities. Among the five-largest publicly traded Chinese banks, 82% of 2008 revenues came from net interest income, 15% was generated by fee-based businesses (credit cards, agency, investment banking, etc.) and the remaining 3% was generated by trading & investment income (see Figure 6).

While the reliance on net interest income is down from 90% in 2003, this figure is still high relative to banks in countries where the banking systems are more mature and fee-generating businesses are more developed. Revenue growth has been strong for the Chinese banks these past five years, with total income growing 21% per annum as net interest income has grown 19% per year and non-interest income has increased 48% per annum” (see Figure 7). (p.17)

Figure 6. Breakdown of the five-largest publicly traded Chinese Bank’s income. Source: (Werner & Chung, 2010)

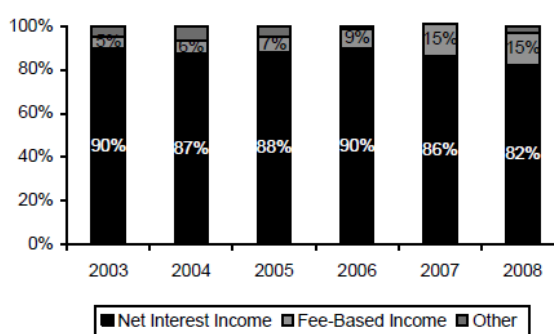
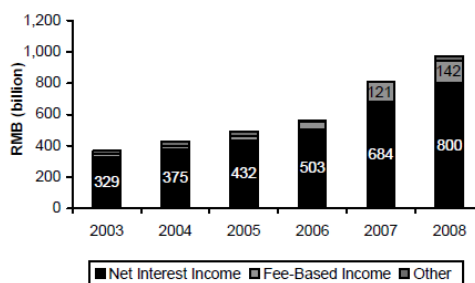


Figure 7. Operating income of the five-largest publicly traded Chinese banks. Source: (Werner & Chung, 2010)



As stated in a study (Werner & Chung, 2010) income in China’s banks comes mainly from corporate banking where credit to enterprises is preferred over credit to individuals and in terms of business segment (see Figure 8 and Figure 9):

From a business segment perspective, 50-55% of the operating income and 50-60% of the net income of the major Chinese banks is generated within their Corporate Banking divisions. About 30% of operating income and net income comes from the banks' personal banking division and the remaining 15-20% is generated in the banks' Treasury division. (p.17)

Figure 8. Operating income breakdown by business segment. Source: (Werner & Chung, 2010)

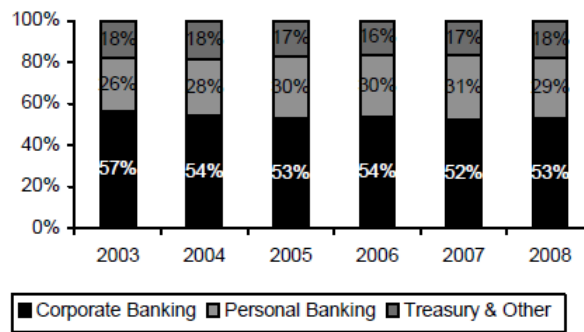
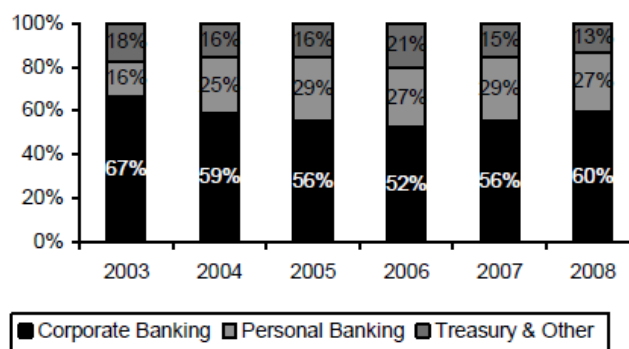


Figure 9. Pre-Tax profit breakdown by business segment. Source: (Werner & Chung, 2010)



3.1.5.3 MAJOR COMPONENTS OF CHINA'S BANK REVENUES: INTEREST INCOME

In the banking industry the interest income comes from loan books. From Figure 10, it can be seen that in China "...just as the revenues and profits for the banks are skewed toward corporate banking, so too are the loan books of nearly all of China's large commercial banks. Just 18% of loans outstanding at China's banks are to the residential sector" (Werner & Chung, 2010). In addition, "the retail banking market is relatively undeveloped in China. Consumer lending (which accounts for about 70% of all personal lending in China) has grown from virtually zero in 1997 to about 12.5% of total loans outstanding at the end of 2008. Most of the growth in this business occurred over the five-year period from 1999 to 2004," (Werner & Chung, 2010) (see Figure 11).

Figure 10. China Bank's Domestic Loan Portfolios 2008. Source: (Werner & Chung, 2010)

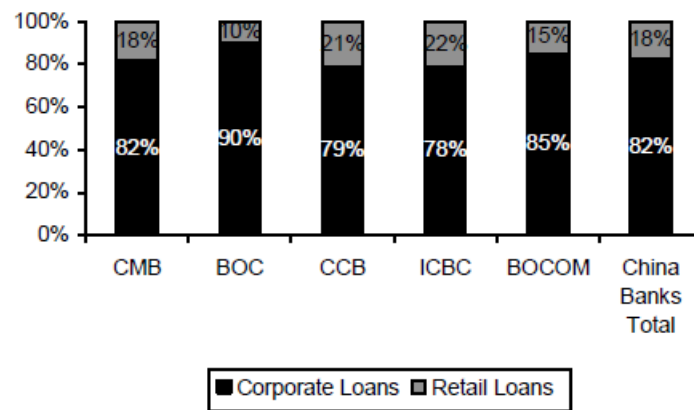
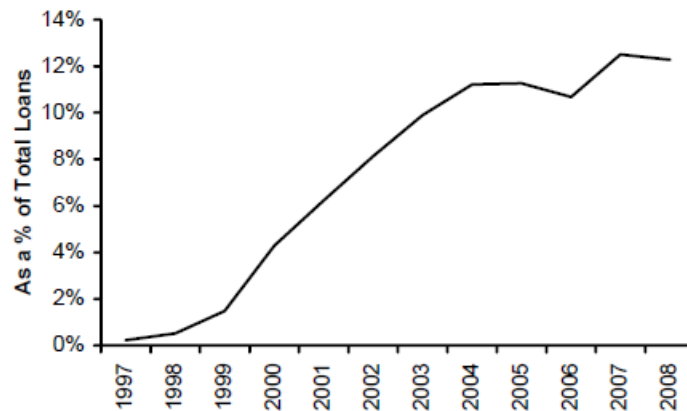


Figure 11. China Consumer Lending as a Percentage of Total Loans. Source: (Werner & Chung, 2010)



The preference to give loans to enterprises over individuals has the following reasons, that has its roots in the lack of information (an institutional void in which it is further developed). In opinion of a study (Werner & Chung, 2010):

- First, there was no national credit database for individuals until late 2004, making it difficult to know an individual's credit or payment history.
- Second, collateral values (in the event of a loan default) were more fungible for enterprises than for consumers. In addition, personal bankruptcy law is still relatively untested in China and recovery values for personal loans are less than those for corporate loans.
- Third, corporate loans have historically been more profitable than loans extended to individuals, largely driven by the higher overhead costs per dollar of credit extended for personal loans.

3.1.5.4 MAJOR COMPONENTS OF CHINA'S BANKS REVENUES: FEE-BASED BUSINESSES

According to a study (Werner & Chung, 2010) "While the banks generate the bulk of their income from the traditional commercial banking business, a growing portion of income is being source from fee-based businesses" (see Figure 6 and Figure 7 in p. 13) . Furthermore, the study (Werner & Chung, 2010) states that:

The Chinese banks operate six major fee-based businesses on the Mainland:

- Wealth management services;
- Consulting & advisory;
- FX settlement & clearing;
- Bank cards (debit & credit);
- Credit commitment & loan guarantees; and
- Asset custody (p.17)

These fee-generating businesses are all at different stages of maturity and therefore have a high potential of growth that I will comment in section "arbitrage" the distance in maturity of the fee-based businesses (p.36).

3.1.5.5 MAJOR COMPONENTS OF CHINA'S BANKS REVENUES: BILL FINANCING

According to (Werner & Chung, 2010):

Bill financing (or discounted bill financing) is a unique banking product in China. By definition, bill financing is short-term in nature with maturities often six months or less and is extended to enterprises (not individuals). These short-term loans are usually used to finance working capital, as in trade or near-term transactions. Banks extending bill financing often demand collateral in the form of account receivables or corporate deposits. This form of credit is associated with low default rates due to its short durations (though a bill that becomes non-performing is usually classified as a traditional corporate loan which makes it difficult to know the true default rate of this product).

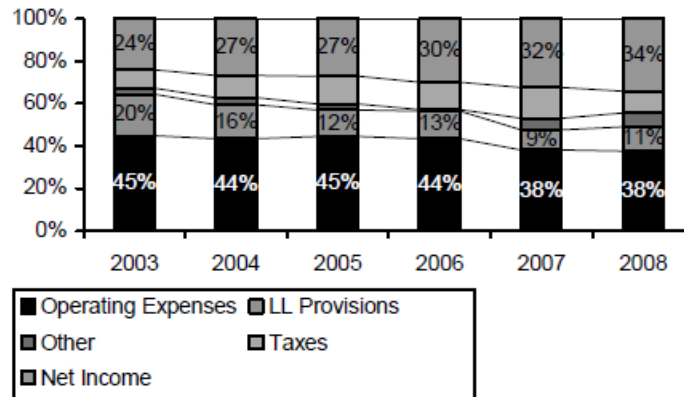
In early 2009, bill financing accounted for a large portion of bank credit extended. At the end of 1Q:09, bills outstanding were 10% of total loans extended, up from 5% six months prior as 37% of all credit granted in 4Q:08 and 1Q:09 was in bill financing format. (p.22)

3.1.5.6 MAJOR SOURCES OF COSTS IN CHINA'S BANKS:

In the cost side, China's banks, according to (Werner & Chung, 2010):

While revenues grew at a 21% annual rate, operating expenses have grown by just 17% annually over 2003-08 and loan-loss provisions grew just 8%. As a result, net income for the banks we've examined has grown 30% per annum. Additionally, after-tax profit margins improved from 24% in 2003 to 34% in 2008 (see Figure 12)

Figure 12. As a Percentage of Operating Income. Five Large Chinese Banks. Source: (Werner & Chung, 2010)



The five largest publicly traded banks have enjoyed a sharp reduction in the level of NPLs over this time frame, partially because of the government-sponsored restructurings and partially due to the improving economic environment within China over this time frame (...). Credit quality has improved for all of the Chinese banks over the past six years (pp.18-19)

3.2 TRENDS IN BOTH THE INTERNATIONAL AND CHINESE MARKET ENVIRONMENT AND THEIR IMPLICATION FOR THE FUTURE.

3.2.1 TRENDS IN CHINESE MARKET ENVIRONMENT

In the Chinese market, the non-market environment will play a significant role in the future of the China's banking industry. However, trends are subject to scenarios triggered by economic and political events, as I will try to show.

3.2.1.1 POLITICAL TRENDS

It is expected the following political trends, according to some analysts (Business Monitor International, 2011):

- "China's expanding economy is gradually giving it greater clout in international affairs, which will allow it to build politically important ties, especially with the developing world." "China is expanding its political and economic ties with major emerging markets in Latin America, Africa and the Middle East..."
- "A new generation of leaders (the 'fifth generation') is being prepared to take power in 2012-2013. This should ensure the continuation of reform and modernisation. ..."
- "Growing corruption, widening inequalities, increasing rural poverty and environmental degradation have led to an increase in social unrest in recent years. ..."
- "The Communist Party is facing increasing factional rifts based on ideology and regionalism. While greater political debate would be welcomed by many, internal regime schisms could be politically destabilising. ..." (p. 7, 8 and 9)

3.2.1.2 ECONOMIC TRENDS AND THEIR RELATIONSHIP WITH CHINA'S BANKING INDUSTRY TRENDS: POSSIBLE SCENARIOS

Analysts consider the future trend in economic growth for China "...more downbeat on its investment outlook as we expect consumer spending to be relatively robust. Indeed, there are clear signs that the Chinese authorities may be targeting a lower loan growth rate for 2011 as they battle with inflationary pressures. As such, we believe that investment loans (especially in the property sector) may be held back in the coming quarters. Accordingly, we are expecting loan growth in China to underperform, reaching just 8.0%, compared to India (18.0%) and Indonesia (20.0%)." (Anon., Q2 2011)

In addition, according to some studies (Anon., 2010) after resisting the current world recession, factors as liquidity tightening, a property market bubble, artificial NPL ratios potentially will hurt growth despite government support. According to those analysts:

The Chinese economy has shown tremendous resilience during the recession, largely due to unprecedented levels of government stimulus offsetting weaker global demand growth for Chinese exports. Much of this stimulus was channelled via government-directed bank lending and a sizeable amount of it has found its way into property investment.

However, as 2010 unfolds and liquidity tightening measures are increased, we expect loan growth in China to slow, revealing the effects of the bad loans made in recent years. More pointedly, we are increasingly concerned about the prospect of financial turbulence if the property market bubble bursts. With credit still in abundant supply, we believe that non-performing loan (NPL) ratios are likely to remain low for the time being. The average NPL ratio hit a nadir of 1.58% in December 2009.

But we think that banks are likely keeping some poor credit risks liquid with increasing amounts of debt, which, along with innovative accounting practices, is helping to keep the NPL ratio low. At some point, which we believe will come in the latter stages of 2010, loans to property developers and manufacturers may have to be called in if the central bank is forced to tighten liquidity, which will cause the NPL ratio to spike.

Of course, with the state banks accounting for the bulk of new lending in China, we believe the government will support the system if banks get into trouble. As has been the case in the aftermath of rising NPLs following government-driven lending booms, Beijing is likely to pick up the tab by taking the loans off the balance sheets of state-owned banks and issuing bonds to pay for them. Still, any shakeup in the Chinese banking sector presents major contagion risks elsewhere in the world, by raising risk premiums and potentially derailing Chinese growth, which has been at the heart of the global recovery. (pp.14-15)

Furthermore, China's government is implementing policies aimed to prevent an economic weakness and future social unrest, according to some analysts (Werner & Chung, 2010):

The central bank and the banking regulators in China encourage banks into expanding services to areas of the market that are under-banked (e.g., individual consumers, SMEs, rural areas). Not surprisingly, these segments of the market are under-banked because they are less profitable to the commercial banks. As a result, regulators often have to subsidize the banking activities to these segments/cohorts in the form of reduced capital or regulatory requirements.

For instance, the central bank has encouraged banks to increase services to rural residents and enterprises (...). In addition, the central bank has encouraged the establishment of rural finance companies to give residents access to credit to facilitate the purchase of durable consumer goods such as automobiles and large electronic appliances.

The goal of these initiatives is twofold. Firstly, these initiatives increase domestic demand, especially from the less-consumption-focused rural residents in the hopes that it can mitigate the weakness in foreign demand driven by the global recession. Secondly, by offering greater access to traditional banking services and financing, the Chinese government hopes to bridge the widening prosperity gap between urban and rural residents, thus improving the social harmony of the country. (p.36)

Considering the above, there are several possible scenarios triggered by the economic events to consider:

3.2.1.3 SCENARIO: RECENT YEARS OF GROWTH ARE NOT SUSTAINABLE

Considering the clear interrelation between the economy and the financial system, “The largest risk to the Chinese banks would be a sharp downturn in the Mainland's economy.” (Werner & Chung, 2010) Furthermore, given the recent development of the China's banking industry, the recent years of growth are not sustainable for several reasons according to (Werner & Chung, 2010):

- 1) China has benefited from 19 consecutive years of real GDP growth above 7%, it is difficult to ascertain the credit quality and earnings impact on the Chinese banks in an environment where economic growth slowed to the low single digits. Nonetheless, we believe that such a scenario would have a seriously negative impact on the earnings and valuation of the Chinese banks. (p.50)
- 2) The average Chinese bank enjoyed 35% annual earnings growth between 2005-08 driven by strong operating leverage, a favourable macroeconomic environment and rapid balance sheet expansion aided by the capital raised from their equity listings.
- 3) The banks' net interest margins peaked in 2008,
- 4) China's economy, while still strong, will no longer grow at the lofty rates seen pre-global financial crisis,
- 5) The excess capital of the banks has largely been depleted. As a result, we forecast earnings growth at the banks will average 14% per annum over 2008-11, a sharp deceleration from recent levels and 500 bp below consensus earnings growth forecasts. (p.51)

3.2.1.4 SCENARIO: A SUDDEN CHANGE IN POLICY

According to (Werner & Chung, 2010) the other major risk is sudden change in policy related to regulation of the financial industry, for instance:

- We would view any increase in foreign competition (beyond the expected growth of Hong Kong banks in China, helped by the recent CEPA agreements) as a negative for the Chinese banks. If, for instance, the Chinese government made it easier for U.S. and European banks to expand their footprint in China and compete more directly with the domestic banks, we would expect to see increasing pricing pressure and lower profitability from the banks we cover. Currently, foreign banks control just 2% of China's banking market share.
- Any policies that accelerate the trend of bank disintermediation (...) would have negative implications for the earnings of the Chinese banks we cover. For example, the lifting of the ceiling on bank deposit interest rates would increase competitive pressure as banks attempt to gain market share via pricing. This in turn would result in weaker net interest margins and lower profitability for the Chinese banks. While we believe these trends are inevitable in the long term, should they occur now, the banks' other income streams (fee-based businesses)

are not developed enough to offset a substantial decline in profitability from their traditional commercial banking business.

- In terms of monetary policy, a rapid increase in lending and deposit interest rates (assuming the adjustments were parallel) would be a positive for the net interest margins of the banks. The Chinese banks are asset-sensitive (which means the interest-rate-sensitive assets reprice faster than liabilities) and would benefit from rising rates. We forecast interest rates will remain at current levels until very late in 2010, when we expect the central banks will increase them to fight inflationary pressures. (pp.50-51)

3.2.1.5 SCENARIO: BANKING CRISIS BECAUSE OF DETERIORATING NPL'S

According to a study (Werner & Chung, 2010) "China's banking regulators are becoming increasingly concerned about the potential for credit quality deterioration in the coming years at China's commercial banks." The study states that:

Total loans outstanding as a percentage of nominal GDP was 105% in 1999, and fell back to that level in 2008 before the massive surge in 1H:09 loan growth pushed loans as a percentage of nominal GDP above 125%, the highest level ever in China. (p.14)

Given the size of the loans in the economy (Allen et al., 2005) argues that NPL's are a key risk factor:

If non-performing loans (NPLs) continue to accumulate and/or if growth slows significantly then there may be a banking crisis in China. This may well involve withdrawal of funds from banks. However, given the government's strong position regarding the low level of debt (...), it should be possible for the government to prevent this situation getting out of control. On the other hand, given that the real estate market in Shanghai and in other major cities (largest volume and most developed) has already gone through a few episodes of bubbles and (...), it is quite possible that similar episodes in the future could cause a banking crisis that will be more damaging to the real economy. With booming real estate markets, there will be more speculative money poured into properties with a large amount coming from bank loans. The agency problem in real estate lending and investment mentioned above worsens this problem. If the real estate market falls significantly within a short period of time, there could be large defaults on bank loans that can trigger a banking panic and crisis. This perhaps represents the most serious risk of a financial crisis in China.(p.60)

3.2.1.6 SCENARIO: CURRENCY CRISIS AND BANKING CRISIS

According to (Allen et al., 2005):

A currency crisis that may trigger a banking crisis is a possibility. The rapid increase in foreign exchange reserves in recent years suggests there is a lot of speculative money in China in anticipation of an RMB revaluation. If there is a revaluation or if after some time it becomes clear there will not be one then much of this money may

be withdrawn. If they (the government) allow the currency to float so they do not use up the exchange reserves then any falls in the value of the RMB may occur quickly and this may limit further outflows. If they try to maintain the peg then there may be a classic currency crisis. This in turn may trigger a banking crisis if there are large withdrawals from banks as a result. Quickly adopting a float and avoiding a twin crisis would be much preferable. (p.62)

3.2.1.7 SCENARIO: FINANCIAL CRISIS CONTAGION

Financial crises are contagious as seen in recent events and are another possibility in the future of China's banks. According to (Allen et al., 2005):

... in the Chinese context where financial markets are relatively unimportant it is most likely they will occur either from contractually interconnected financial institutions or large asset price movements that cause spillovers to financial institutions.

(...) China's interbank market grew very quickly since its inception in 1981; in fact, the growth of this market was so fast, with the participation of many unregulated financial institutions and with large amount of flows of funds through this market to fixed asset investment, that it exacerbated high inflation in the late 1980s. Since then the government and PBOC increased their regulation by limiting participation of non-bank financial institutions and by imposing restrictions on interest rate movements. In 1996 a nation-wide, uniform system of interbank markets was set up. (...). ...the growth of trading volume of instruments with short maturities (overnight and one week) has been fast, while trading of securities with longer maturities has been low and steady. It can be seen that interlinkages are significant and potentially create a possibility for contagion.

With regard to a meltdown of asset prices, this can happen because of a limited supply of liquidity if there is a rapid liquidation of assets. It seems unlikely that this can occur and cause a serious problem in China's securities markets. A more serious threat is real estate markets if there are bankruptcies and forced selling. This could potentially interact with bank interlinkages and cause a systemic problem. As mentioned above, a crash in real estate markets is probably the most likely cause of a financial crisis in China. (p.62-63)

3.2.2 TRENDS IN THE INTERNATIONAL BANKING MARKET ENVIRONMENT

In this section, I present the main trends that some analysts consider will influence the international market environment:

- A global banking industry recovering from the crisis of 2008 fearing an economic slowdown in the developed world but expecting a better performance in the emerging markets.
- An increased tightening in regulation
- A surge in asset prices in the Asian region

Global banking industry recovering, according to (Anon., 2010):

The global banking sector continues to heal from a tumultuous 2007-2009. Major banks across the world have taken advantage of generally favourable conditions, including central bank and government support, a steep yield curve allowing for profitable short-term borrowing and long-term lending, a stabilisation in asset prices, and a recovery in global risk appetite. Banks are by no means out of the woods however, and we continue to forecast a deceleration in the US and Chinese economies and an overall global slowdown from 3.2% growth in 2010 to 3.1% in 2011. This, along with household balance sheet rebuilding in most developed states, will keep banks far from staging a recovery to pre-crisis loan growth levels. ***We continue to be more optimistic about the prospects for banking sectors in the emerging markets, which have held up well during the recession and will continue to take advantage of relatively low leverage and penetration levels to grow throughout the coming decades.*** (p.13)

Increased tightening in regulation according to (Anon., 2010):

Tighter banking regulation is certain to be a major theme (and risk) in 2010-2011, (...) While we expect new financial regulations to affect large investment banks more than traditional lenders such as commercial and regional banks, they are likely to have an impact on the whole financial arena. Under bills being considered in the US Congress, for example, financial firms would be forced to keep greater cushions against losses and the government would exercise greater regulatory control over mortgages and derivatives. More sweeping reforms would essentially reintroduce the Glass-Steagall Act, separating investment and commercial banking operations.

On a global level, there has been increasingly serious discussion about the imposition of Tobin financial transaction taxes, higher capital adequacy ratio requirements, increased regulatory oversight of a vast array of banking functions and a tax on bank's profits. The outcome of such proposals is made all the more unpredictable by populist rhetoric from politicians, many of whom see banks as easy targets.

Ultimately, tighter regulation may lead to a safer but less profitable banking system, although this will depend on the extent to which banks are able to circumvent new regulations. For example, to deal with bans on high-risk activities, banks are likely to increasingly resort to spinning off risky assets to separate companies, thereby dissociating

themselves from the risk on the face of it but retaining a potential relationship with the profits it could generate. (p.15)

The risk of surging asset prices according to (Anon., Q2 2011):

A prolonged period of easy monetary conditions in the developed world since the height of the global financial crisis in Q109 has led to a wall of funds flowing from the US and the eurozone into Asia. While these fund flows have not proven to be destabilising for the Asian financial markets yet, some worrying symptoms have emerged. These include surging asset prices and rising consumer price inflation. Should foreign investors embark on a disorderly unwind of positions in Asia, stress resulting from foreign exchange fluctuations and declining property prices would be placed on the balance sheets of Asian banks. In the current situation we believe that currency volatility is less of an issue, whereas a crash in property prices is a key concern. Indeed, for Indonesia, Thailand and South Korea (the three economies whose currencies were worst hit in 1997/98), the authorities have already stepped up capital controls to prevent excessive speculation (...).

Property prices will prove trickier to handle. A collapse in real estate prices will impact on the banks' loan portfolio and overall profitability will consequently be hit amid a rise in non-performing loans. Anecdotal evidence and official data in several Asian economies including China, Singapore, Hong Kong and South Korea suggest that prices are close to or have already pushed past their pre-crisis peak. (pp. 22-23)

3.3 ANALYSIS OF THE EXTENT TO WHICH THE CHINESE MARKET IS UNIQUE OR DIFFERENT TO MOST OTHER DEVELOPED MARKETS

In my opinion, the uniqueness of China's banking market emerges from the non-market environment characteristics of the Chinese market and, specifically, from their institutional voids. These institutional voids constituted the so-called "CAGE distances" (Ghemawat, 2007). However, the same threats constitute an opportunity for potential benefits for those who can deal with them. In this way, based in the methodology of non-market environment analysis (Khanna et al., 2005; Baron, 1995) I have identified the following key institutional voids that blend in a mixture of issues, institutions interest and lack of information:

1. Immature financial market and young banking industry
2. Poor self-regulation and formal regulation: poor disclosure rules, accounting standards, and judicial systems
3. The large overhang of shares owned by government entities.
4. The lack of trained professionals.
5. Limited financial markets and products.
6. Inefficient finance allocation: financial intermediation monopoly and capital controls

3.3.1 IMMATURE FINANCIAL MARKET AND YOUNG BANKING INDUSTRY

According to (Werner & Chung, 2010):

The history of commercial banking in China is only about 25 years old. And while its banking system relative to other more-developed countries is immature, China's financial markets are even more immature. The equity markets in China, nearly two decades old, are volatile as they lack a stabilizing diversified institutional investor base. And the fixed-income market (both exchange-traded and over-the-counter) is dominated by government issuance as the corporate debt market is hampered by weak secondary liquidity and an untested bankruptcy law. (p.13)

1. Poor self-regulation and formal regulation:

Usually regulation in developed markets is where the government regulation is minimal and markets behave well, as argued by (Allen et al., 2005): "A good example of regulation through market forces and self-regulation is provided by the capital markets in the UK in the nineteenth and early twentieth centuries (Michie, 1987). The role of government regulation and intervention was minimal. Despite this the markets did extremely well and London became the financial capital of the world."

In addition, factors of trust and reputation are "important factors in the smooth operations of these markets." (Allen et al., 2005)

However, in the case of China, (Allen et al., 2005) argue that "examples of fraud and manipulation... suggest that in China's formal financial markets these alternative mechanisms do not work well.

Although such mechanisms may develop in the very long run as in the nineteenth and early twentieth century UK , it seems that in the short run at least it is likely to be necessary to have formal government regulation of the type developed in the US in the 1930s as a response to the stock market collapse that started in 1929 and the Great Depression.”

Specifically, the deficient regulation lies on China’s poor disclosure rules, accounting standards, and judicial systems, as explained below:

1.1. Poor disclosure rules, according to (Allen et al., 2005):

“One of the most important functions of a financial system is the acquisition and use of information to facilitate the efficient allocation of resources. China is in the process of improving its accounting and related disclosure standards, particularly for publicly listed and traded companies. This is important and should be done with due diligence. Lessons can be drawn from various countries’ experience. However, the importance of improving accounting standards should not understate the importance of an efficient banking system, in particular, one that provides funding and monitoring to firms. This is true also because the status of China’s accounting profession makes it difficult to quickly improve the transparency of the markets.”

1.2. Poor accounting standards: according to (Allen et al., 2005)

“The accounting reform started with the enactment of regulations governing the enterprises with foreign investment, which provided the necessary accounting infrastructure to assist companies in attracting foreign direct investment. The ASBE (Accounting Standards for Business Enterprises) of China, together with the 13-industry regulation board, have been trying to move China’s accounting practice of SOEs toward the IAS (International Accounting Standards). However, the most glaring problem in China’s accounting system is the lack of independent, professional auditors, similar to the situation of legal professionals. The added problem on the reform of the accounting system stems from the lack of an effective judicial system to protect companies’ assets from embezzlement and other frauds. This implies that the proposed IAS-based standards may be counterproductive within China’s current infrastructure: With few auditors understanding and enforcing the new standards, and given the lack of an effective judicial system, embezzlement of company assets and other forms of fraud may occur more frequently under IAS-based standards, as compared to an alternative system with a much simpler set of accounting standards”. (p.43)

3.3.2 THE LARGE OVERHANG OF SHARES OWNED BY GOVERNMENT ENTITIES

According to (Allen et al., 2005):

One of the major problems Chinese stock markets face is caused by the large amount of shares in listed companies owned by the government and government entities shown in Table 6-B. This overhang creates great uncertainty about the quantity of shares that will be tradable going forward. Investors fear that if prices go up then the government will sell their holdings and this will prevent further price rises or even depress them. This uncertainty has caused share prices to stagnate despite the very high levels of growth in the economy. In

order to remove this uncertainty, the government should announce a plan for selling these shares slowly over time. Each year a small amount (i.e. small relative to the usual amount traded) would be sold so that the market could easily absorb the shares. Such a plan might take several decades to complete. (pp.43-44)

3.3.3 LABOUR MARKET: LACK OF PROFESSIONALS

According to (Allen et al., 2005) :

“This is the most important factor in terms of improving the enforcement of laws and contracts. First, an independent and efficient judicial system requires a sufficient supply of qualified legal professionals. The Ministry of Justice of China states that there are 110,000 lawyers and 9,000 law firms as of 2002, while Orts (2001) estimates that there are 150,000 lawyers in China, roughly the same number of licensed attorneys as in the state of California. Lawyers represent only 10% to 25% of all clients in civil and business cases, and even in criminal prosecutions, lawyers represent defendants in only half of the cases. Among the approximately five million business enterprises in China, only 4% of them currently have regular legal advisers. Moreover, only one-fifth of all lawyers in China have law degrees, and even a lower fraction of judges have formally studied law at a university or college. As mentioned before, a similar situation exists for auditors and accounting professionals.” (p.45)

3.3.4 LACK OF DEVELOPMENT OF MORE FINANCIAL PRODUCTS AND MARKETS

According to (Allen et al., 2005) :

Another issue is to develop more financial products so that investors can form diversified portfolios with more than just stocks. First and foremost, corporate bond markets should be developed, along with better enforcement of bankruptcy laws and bond rating agencies. Second, more derivative securities such as forwards, futures, and options on commodities (already in place and trading) as well as on other securities should be introduced to the market, so that investors and firms have more tools for risk management. Third, insurance companies should offer more products related to property insurance and auto insurance, while other financial services companies should develop the market for asset-backed securities. (p.46)

3.3.5 INEFFICIENT FINANCE ALLOCATION: FINANCIAL INTERMEDIATION MONOPOLY AND CAPITAL CONTROLS

The inefficient financial allocation is due to capital controls according to (Werner & Chung, 2010):

“China has imposed strict capital controls on its populace (by limiting their investment opportunities to products in the domestic market), result in bank deposits being the most liquid and preferred financial investment in China, both by individuals and non-financial enterprises.”(p.13)

Furthermore, the study considers that “this is an inefficient use of capital ... until the Chinese create liquid and robust debt capital markets, we are not likely to see substantial changes in the corporate financing system.” (p.16)

3.3.5.1 MONOPOLY IN LOANS:

According to a study (Werner & Chung, 2010) “the Chinese banks enjoy a special role in China’s financial system. As a group, they have a virtual monopoly on financial intermediation in China”. As Figure 13 shows, “most of the funding for non-financial enterprises in China has come from bank loans. On average, 70% of corporate funding was provided by bank loans over the past 15 years, 7% came from the sale of securities (both equities and bonds) and 21% came from foreign direct & other investment” (see Figure 14). “We note that a larger portion of corporate financing came from the sale of securities (both equity and fixed income) over 2000-06, relative to 1992-99 (10% versus 5%) as corporate bond issuances and initial public equity offerings have both increased since 2000.”

Figure 13. Non-financial enterprises: Sources of financial funds. Source: (Werner & Chung, 2010)

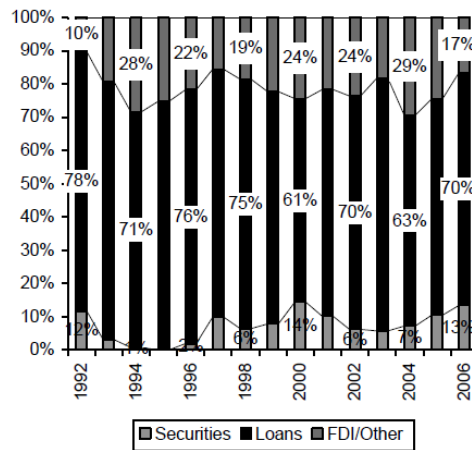
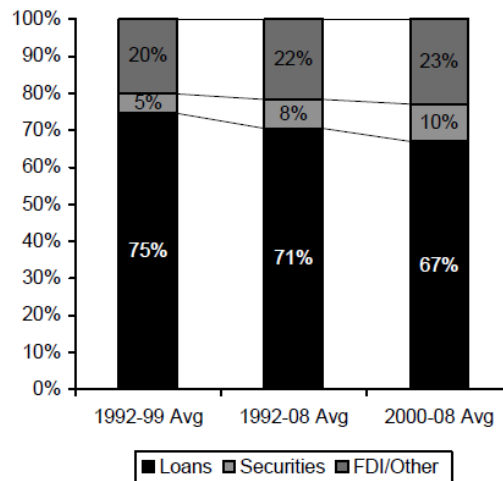


Figure 14. Non-financial Enterprises: Sources of financial Funds. Source: (Werner & Chung, 2010)



This Bank's virtual monopoly on financial intermediation in China is due to the current very limited set of financing channels. According to (Allen et al., 2005):

The four most important financing sources for all firms in China, in terms of firms' fixed asset investments, are: (domestic) bank loans, firms' self-fundraising, the state budget, and foreign direct investment (FDI). By far the two most important sources of financing channels are self-fundraising and bank loans. Consistent with previous evidence on China's banking sector, bank loans, including loans from the non-state banks, provide a large amount of funds to firms, and constitute a large fraction of firms' total financing needs (...) For example, firms in the State Sector rely on bank loans to raise more than 25% of their total financing needs (...)

Self-fundraising includes proceeds from capital raised from local governments (beyond the state budget), communities and other investors, internal financing channels such as retained earnings, and all other funds raised domestically by the firms.

It is important to point out that equity and bond issuance, which are included in self-fundraising, apply only to the Listed Sector, and account for a small fraction of this category. Moreover, self-fundraising is the most important source of financing for many types of firms. For example, individually owned companies (of the Hybrid Sector), not surprisingly, rely mostly on self-fundraising (about 90% of total financing). Interestingly, even for state- or quasi-state-owned companies, self-fundraising is also important in that it captures somewhere between 45% and 65% of total financing.

The state budget and Foreign Direct Investment (FDI) are the other two important financing sources. As was the case for all socialist countries, China used to rely on a central planning system to allocate the state budget to most of the companies in the country. But the state budget now only contributes 10% of state-owned companies' total funding. On the other hand, FDI is comparable to the state budget, both in terms of aggregate size and in terms of the relative importance in firms' financing. This evidence confirms that China has evolved from a centrally planned, closed economy toward an open market economy. For example, in terms of the ratio of FDI over GDP, China attracted more FDI than both South Korea and Taiwan during the 1990s. (pp.11-12)

In addition, there is a high reliance upon bank loans in China relative to both more-developed Western economies and economies in China's neighbouring countries. According to (Werner & Chung, 2010):

...reliance on bank-based funding has declined over the past two decades, a trend that should continue as debt capital markets become more liquid in China and IPOs continue to be issued (...). While we expect Chinese corporations to reduce reliance on bank funding in the coming years, we believe that the banks' role as the main financial intermediary will remain for at least the coming decade. Before the financial markets in China disintermediate from the banks, a more robust and mature corporate debt market will have to be

established” ... “the corporate debt market is very much in its nascent stages in China. Until 2005, most of the security financing for non-financial enterprises came from the sale of equities, not the issuance of corporate debt. While corporate debt issuance has improved since 2005, the overall debt capital markets in China remain small (as a percentage of GDP and total financing) than most developed countries. (p.15)

3.3.5.2 MONOPOLY IN DEPOSITS:

In the opinion of a study (Werner & Chung, 2010), inefficient capital markets drive the non-financial corporations to not only borrow from banks for funding demands (which is less efficient than using a corporate debt market or raising equity) but also obligates non-financial corporations to put their funds mostly in short deposit banks (less efficient than other allocations). They currently contribute a significant portion of bank’s deposits (40%, see Figure 15 and Figure 16). The major factors for this, also according to (Werner & Chung, 2010) are:

- First, most Chinese non-financial enterprises do not have access to short-term funding markets, such as the (usually) liquid corporate commercial paper market in the developed markets of the U.S. and the EU. The commercial paper markets in the EU and the United States are largely available only to investment-grade companies, limiting most enterprises as China lacks an established corporate credit rating system and only the largest firms in China carry credit ratings. Thus, Chinese corporations typically maintain liquid savings balances in banks in the form of deposits in the event they find themselves lacking short-term funding.
- Second, funding desks are few and far between among Chinese non-financial enterprises. Given the lack of disintermediation in the Chinese financial market, corporate treasurers have a relatively easy decision-making process in China regarding where to place surplus funds — bank deposits. Until a deep and liquid corporate money market industry is established in China, we would expect corporate cash surpluses to continue to flow into banks.
- Third, without a robust and long-dated track record of corporate credit ratings in China, banks typically demand some type of collateral against most types of loans. In many cases, the collateral used is in the form of corporate deposits at the respective bank. (p.16)

Figure 15. Sources of Deposits at financial institutions. Source: (Werner & Chung, 2010)

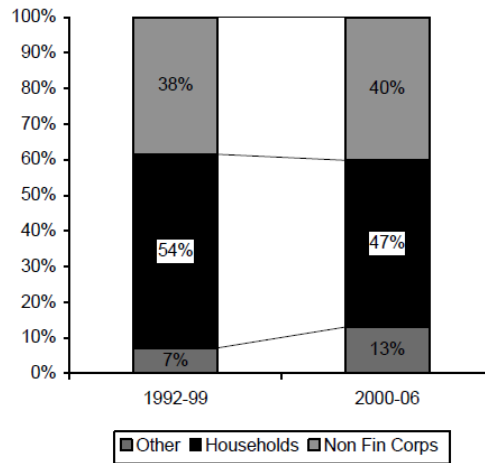
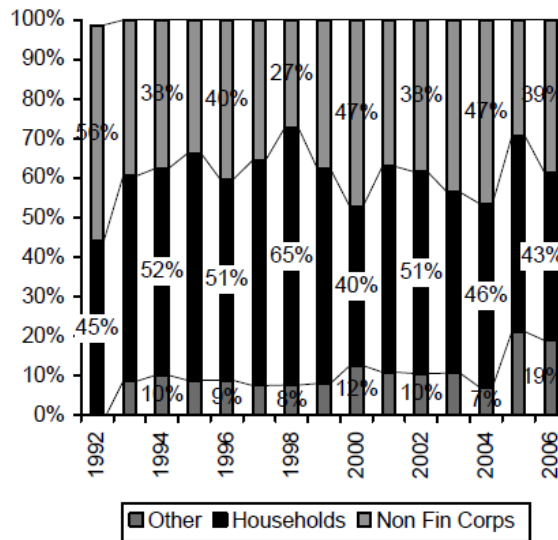


Figure 16. Sources of Deposits at Chinese Bank. Source: (Werner & Chung, 2010)



3.4 AN ANALYSIS OF WHETHER CHINESE FIRMS CAN COMPETE WITH MULTINATIONAL FIRMS IN THEIR HOME MARKET.

The incursion of multinational banks in China is very recent and limited. “China’s financial reform stalled and the country has never truly opened itself up to the world. Foreign firms hold trivial amounts of domestic financial assets (under 2%), and play only a marginal role in any domestic sector.”

“There have been some advantages in this. Chinese banks were not, in the main, exposed to toxic Western debt and, perhaps more importantly, never adopted dangerous Western methods of hiding risks. But China’s own approach presents these problems in a different form.” (The Economist 11 December 2010)

Furthermore, I will show that multinational banks have very limited opportunities due to the “CAGE distances” present. According to (Werner & Chung 2010):

The Chinese banking market is dominated by large, domestically incorporated institutions, with the top four banks controlling nearly 50% of China's banking assets. Meanwhile, foreign-owned depository institutions have just 2% share of the country's banking market.

Only in the past couple of years have Chinese banking authorities allowed foreign-controlled banks to provide local currency banking services in China, and often they have done so with restrictions. Historically, the central bank and regulators were very protective of domestic banking market to foreign competition.

It was China's induction into the WTO that forced the country to slowly open up its banking market to foreign competition. But still, to this day, foreign-owned institutions must comply with more stringent regulations than domestic institutions when seeking to expand their branch networks and business operations in the Mainland, effectively creating a barrier to entry. (p.33)

As we have seen from the special characteristics that make the Chinese market unique and different to most other developed markets, it can be stated that multinational banks have very limited opportunities and great disadvantages to compete with local firms. And maybe the principal reason is the advantage of local banks in navigating institutional voids and the cultural advantages of Chinese firms in better understanding the customers/suppliers and the government (usually the owner), as well as administrative advantages in government policies as protections, industry promotions, and regulations (see the previous analysis in p. 25-31):

However, there are still opportunities worth seizing and they can be available if multinational banks can deal with the “CAGE distances” (Ghemawat 2007), and I present below the different distances to overcome by multinational banks if they plan to compete in China.

3.4.1 ANALYSIS OF “CAGE DISTANCES” IN CHINA’S BANKING INDUSTRY

Following the methodology of CAGE distances (Ghemawat 2007), identification is possible of the differences that multinational competitors need to overcome to succeed in China’s banking industry. For this endeavour I have used studies that compare to other countries, (see Figure 17), in terms of size, cost efficiency and development.

Figure 17. Comparison of Financial Systems: Bank- vs. Market-based Measures (Value-weighted approach). Source: (Allen, Qian & Qian 2005)

	Measures	English Origin*	French Origin*	German Origin*	Scandinavian origin*	Sample average	China
Bank and Market size	Bank credit/GDP	0.62	0.55	0.99	0.49	0.73	1.11 (0.24) ^a
	Overhead Cost/Bank Total Assets	0.04	0.05	0.02	0.03	0.03	0.12
	Total value traded/GDP	0.31	0.07	0.37	0.08	0.27	0.11
	Market Cap/GDP	0.58	0.18	0.55	0.25	0.47	0.32
Structure Indices: Markets vs. banks**	Structure Activity	-0.76	-2.03	-1.14	-1.83	-1.19	-1.07 (0.46) ^a
	Structure Size	-0.10	-1.05	-0.77	-0.69	-0.55	-1.24 (0.29) ^a
	Structure Efficiency	-4.69	-6.00	-5.17	-6.17	-5.17	-1.48 (-3.07)
	Structure aggregate	1.21	-0.05	0.66	0.13	0.72	N/A
	Structure regulatory	7.02	8.21	10.15	7.72	8.95	16
Financial Development (Banking and market sectors)	Finance activity	-1.18	-3.38	-0.84	-2.86	-1.58	-0.85 (-2.38)
	Finance size	5.10	4.29	5.22	4.60	4.95	-1.02 (-2.55) ^a
	Finance efficiency	2.18	0.44	2.85	1.04	2.01	-0.60 (1.14)
	Finance aggregate	1.23	0.13	1.47	0.48	1.05	N/A

*: The numerical results for countries of each legal origin group is calculated based on a value- (GDP of each country) weighted approach; **: Measuring whether a country’s financial system is market- or bank-dominated, the higher the measure, the more the system is dominated by markets; ^a: numbers in brackets indicate bank credit issued to the Hybrid Sector of China (instead of total bank credit);

3.4.1.1 ECONOMIC DISTANCE: SIZE

According to (Allen, Qian & Qian 2005):

“...China’s banking system is much more important in terms of size relative to its stock markets, with its ratio of total bank credit to GDP (1.11) higher than even the German-origin countries (with a weighted average of 0.99). However, when we consider bank credit issued (or loans made) to the Hybrid Sector¹ only, China’s ratio drops sharply to 0.24, suggesting that most of the bank credit is issued to companies in the State and Listed Sectors. Moreover, China’s banking system is not efficient: its overhead cost to total assets (0.12) is much higher than the average of French-origin countries (0.05), the next highest group of countries.” (p.10)

In addition, in terms of size, China’s banking industry is much larger than China’s financial market (see “Structure indices”, second panel of Figure 17), “... and this dominance by the banks over markets is stronger than the average of all sample countries. China has the lowest scores for both ‘Structure Activity’ (ratio of Value Traded/Total Bank Credit) and ‘Structure size’ (ratio of Market Capitalization/Total Bank Credit).” (Allen, Qian & Qian 2005)

3.4.1.2 ECONOMIC DISTANCE: EFFICIENCY

A study (Allen, Qian & Qian 2005, p. 11) suggests that China's banking industry is inefficient compared with China's stock market (see "Structure efficiency" panel in Figure 17, Log of product (Market capitalization/GDP) × (bank overhead cost/bank total assets)), *"which denotes the relative efficiency of markets vs. banks, China has the highest score, suggesting that its stock markets are actually relatively more efficient than banks compared to other countries. This result is mainly driven by the extremely high costs of China's banking system."*

3.4.1.3 ECONOMIC/ADMINISTRATIVE DISTANCE: FINANCIAL DEVELOPMENT

In terms of "Financial Development" (see last panel of Figure 17), which includes both banks and markets, (Allen, Qian & Qian 2005) conclude that:

"...China's financial system is dominated by a large but inefficient banking sector." (...)
"Given that all other countries' measures were based on private bank credit only, if we only include China's bank credit made to the Hybrid Sector¹, we find that China's overall financial market size, in terms of both 'Finance Activity' (Total value traded/GDP) × (Private credit/GDP) and 'Finance Size' (Market capitalization/GDP) × (Private credit/GDP), is smaller than the ... sample average level, and is only higher than the French-origin countries' average. In terms of 'Finance Efficiency' (Total value traded/GDP)/Overhead cost), China's measure is below all sub-samples of LLSV countries." (p. 11)

3.4.1.4 POLITICAL DISTANCES:

"The Communist Party, which has governed for over 60 years, remains secure in its position as the sole political party in China." (Business Monitor International, 2011)

"As with other one-party states, China's political system is inherently unstable and unable to respond to the wider changes taking place in society. Provincial governments often fail to enforce central government directives." (Business Monitor International, 2011)

3.4.1.5 GEOGRAPHIC/ECONOMIC DISTANCES: BARRIERS TO ENTRY

"While domestic competition is strong, Chinese banks face little competition from new and foreign entrants to the market. For the most part, the state-owned banks and the joint-stock commercial banks (of which there are 17 total institutions...) control 65-70% of the assets in the Chinese banking market, with a large majority of the rest of the market controlled by smaller and more-localized commercial banks and cooperatives." (Werner & Chung, 2010)

¹ For (Allen, Qian & Qian 2005), the Hybrid Sector "comprises all the firms that are not state-owned or publicly listed.

3.5 ON THE ADVANTAGES OF MULTINATIONAL BANKS IN CHINA

It was only recently that multinational banks were allowed to operate in China. According to a study (Allen, Qian & Qian 2005):

While foreign banks were allowed to set up representative offices beginning in 1979 (Bank of Tokyo set up the first such office in Beijing), it was not until the later period of 1982 to 1985 that a small number of foreign banks was permitted to set up branch offices (for currency exchange operations) in China's Special Economy Zones. In 1985, the government legalized the status of foreign banks' branches and their operations in the Zones. (p. 7-8)

(...) In 1995, the first joint venture investment bank was formed between Morgan Stanley and PCBC; in 1997, nine foreign banks were allowed to enter the RMB markets and operations in the Pudong Special Zone in Shanghai.(p. 8)

In this sense, the following opportunities are identified for multinational banks entering China, adapted from a recent study (Business Monitor International 2011):

- China continues to open up various sectors of its economy to foreign investment.
- The signing of the memorandum of understanding (MOU) on financial services with Taiwan in 2009 should provide opportunities for the transfer of skills from the more developed Taiwanese banking sector.
- With its vast supply of cheap labour, the country remains the top destination for foreign direct investment in the developing world.
- Increased client demand:
 - Many areas of China lack access to credit markets, which could provide significant opportunities for expansion.
 - China's economic growth is slowly becoming more broad-based, with domestic consumption likely to rise in importance vis-à-vis exports thanks to a middle class of 200-300mn people.
 - China's ongoing urbanisation will be a major driver of growth and new cities will emerge in less developed inland provinces. The UN forecasts China's urban population rising from 40% in 2005 to 73% in 2050: a gain of 500mn people.
 - China's economy grew by 8.7% in 2009, making it the fastest-growing major economy in the world. BMI is forecasting growth to average 7.5% over our 10-year forecast period.
- The large institutions in China's banking system, responsible for the bulk of deposits, have an implicit guarantee from the government and will provide resources in the event of potential crises.

However, to deal with the CAGE distances (see previous analysis in p. 33), requires dealing with the following threats. Adapted from a recent study (Business Monitor International 2011):

- The government will block attempts by foreign firms to take over assets of national importance.
- Foreign companies continue to complain about the poor protection of intellectual property in China.

- Current levels of investment could lead to over-capacity in the future, which might lead to the re-emergence of deflationary pressures and banking sector instability.
- Chinese corporate governance is weak and non-transparent by Western standards. There is a considerable risk for foreign companies in choosing the right local partner.
- The state's involvement in the banking sector means that loans are often granted on political grounds rather than profit maximisation.
- The banking sector is highly susceptible to an increase in non-performing loans (NPLs) which could result from an aggressive increase in interest rates.
 - In addition, there are fears of banks "growing fast, fuelling fears of excessive credit growth." (The Economist 12 February 2011)
- The sudden outflow of hot money from the economy could reduce local money supply, with deflationary consequences.
- China is experiencing rising labour costs, prompting some investors to turn to cheaper destinations such as Vietnam. (In addition, the lack of qualified professionals commented on p. **¡Error! Marcador no definido.**, also consider by another analyst (The Economist 31 July 2010) and the ageing of the population will create a scarcity of Chinese workers (The Economist 2009)
- Close relations between provincial leaders and local businesses is fostering corruption, making it harder for the central government to enforce its policies.

In my opinion, the advantages of multinational firms lie in implementing ADAPT (Ghemawat 2007) strategies and arbitrage in China's business, economic, political environment.

3.5.1.1 "ARBITRAGE" THE DISTANCE IN MATURITY OF THE FEE-BASED BUSINESSES

According to (Werner & Chung 2010):

These fee-generating businesses are all at different stages of maturity. The least mature among the group (and the ones we expect to grow rapidly in the coming years as they develop) are asset custody, financial advisory & wealth management. These businesses are relatively new (about five years old) in China and are far from maturity. As a result, we expect the income generated from these businesses will grow faster than nominal GDP through at least 2015. Meanwhile, the FX settlement business and the loan guarantee and credit commitment business are already mature as commercial banks have been providing these services to clients for the past 20+ years. Thus, it is likely that these two businesses will show slower growth than the undeveloped businesses, increasing in line with China's nominal GDP over the coming decade. The bank card business falls in between the undeveloped and mature businesses as the debit card business is largely mature while the credit card business still is not fully developed. (p.19)

Entering this market, multinational firms could arbitrage the knowledge distance advantage they have. However, they will need to ADAPT to enter the market as we will see below.

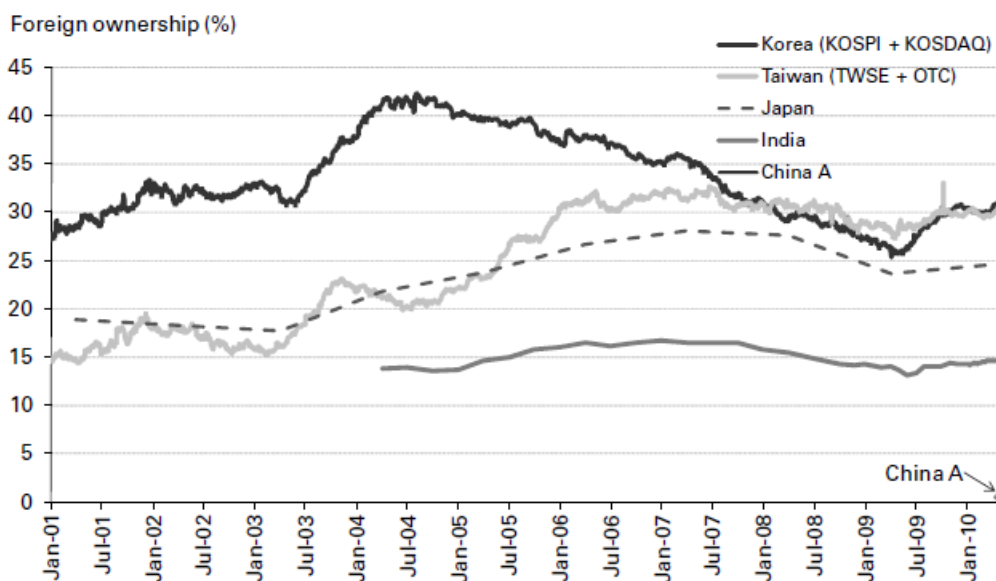
3.5.2 “ADAPT”. NOT TO BUILD A BRAND BUT TO BUY THOROUGH CHINA’S MECHANISMS

According to some analysts (Eoyang, Lui & Koul Junio 2010) there is an underdeveloped opportunity in entering China’s market :

Foreign institutional investors currently access the domestic A-share market via the Qualified Foreign Institutional Investor (QFII) program, which has allowed US\$30bn of foreign investment into A shares, which implies that foreign investors only hold 0.5% of the A share market capitalization.

However, once the currency becomes fully convertible and the A-share market is opened to foreign investors, the potential for foreign participation is likely to jump by an order of magnitude. As shown in (Figure 18. Foreign ownership of major Asian markets. Source:), foreign investors hold 25% of the capitalization in the lower-growth developed market of Japan, 30% in the higher-growth markets of Korea and Taiwan. The lower level of foreign ownership (14%) in India is explained by the weighted average foreign ownership limit (35%), and possibly the fact that the aggregate market currently has the highest valuations in the region. (p.18)

Figure 18. Foreign ownership of major Asian markets. Source: (Eoyang, Lui & Koul Junio 2010)



3.5.3 AVOID: USING ALTERNATIVE MECHANISM TO ENTER CHINA BANKING INDUSTRY

Given that according to (Eoyang, Lui & Koul Junio 2010):

As the domestic equity market grows in stature and liquidity, foreign companies will likely seek to tap that liquidity, especially if they seek funding to expand their activities in China. However, listings of foreign companies are currently not permitted and thus most investment from foreign companies comes via official FDI, which involves a foreign currency to RMB transaction. The government regulates these currency flows, partly because they are the same direction as 'hot money' speculative CNY inflows. (p.21)

An alternative to enter the market could be by establishing a foreign board in Shanghai. According to (Eoyang, Lui & Koul Junio 2010):

The listing of foreign companies would satisfy a number of different objectives for the government:

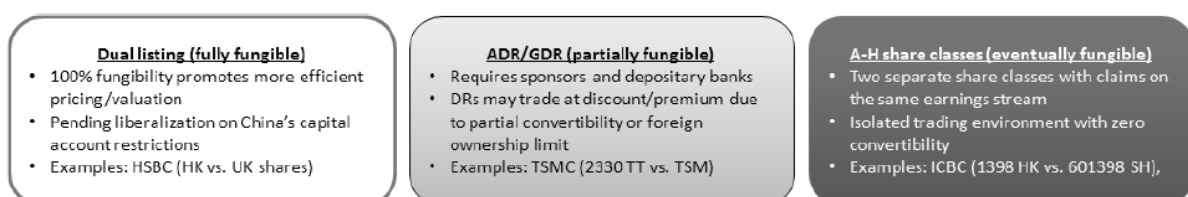
- a) It could be a source of capital for the domestic Chinese operations of foreign companies;
- b) It would give domestic investors direct access to important foreign equities, while remaining under government regulation; and
- c) It would help to soak up abundant local liquidity. Full currency convertibility would not be required for this to move ahead; in fact, it is more likely to proceed if authorities are worried about large FDI inflows into the CNY.

Compared with the QDII system, where domestic institutions raised capital for investment on overseas exchanges, a foreign board has the benefit (from the government's point of view) of being more tightly controlled, while also allowing foreign corporates to raise money for expansion within China. Compared with FDI, which involves selling a foreign currency and buying CNY, this would potentially allow larger domestic investments by foreign investors, without creating large currency flows. (p.21)

In Figure 19, the three most relevant methods for foreign listings are shown:

- Dual listings that are fully fungible between listing locations;
- Depository receipts (ADR/GDR), where fungibility depends on the issue;
- A-H share classes, which are equivalent and which should eventually be fungible (or at least functionally the same).

Figure 19. Commonly-used structure for foreign company listings



For fully convertible dual listings such as HSBC in Hong Kong and London, shares bought on either exchange are legally the same, and price differentials are just a function of arbitrage efficiency and time-zone differences. HSBC also enjoys the possibility of tapping the Hong Kong market with its brand name and its ability to issue its 'bonds'.

The ADR/GDR structure is a way of 'issuing' shares in the international markets by referencing their local shares. Examples include POSCO of Korea (005490 KR vs. PKX US), TSMC of Taiwan (2330 TT vs. TSM US), Vale of Brazil (VALE3 BZ vs. VALE US) and Infosys of India (INFO IS vs. INFY US). The valuation premium/discount of foreign-listed shares is generally a function of the convertibility specifications. As an example, TSMC ADRs are systematically more expensive than their underlying shares in Taiwan due to the non-fungibility and limited availability of ADR shares outstanding. In theory, the valuation of ADR/GDR should be the same as local shares, assuming there is an efficient convergence mechanism.

The dual A/H share structure for Chinese stocks, with separate onshore and offshore shares, which are expected to become equivalent (but with no explicit guarantees), is the most ambiguous of the three structures. The lack of explicit convergence and the fact that the domestic pool of money has had limited investment options has enabled A shares to trade historically at substantial premia to H shares; as domestic money is allowed access to more diversified products, and the prospect of 'convergence' with the H shares improves, these differentials have fallen.

4 WHAT WILL BE THE IMPLICATIONS FOR GLOBAL MARKETS?

It has been said that, in the future, it is expected that “as China moves up the value chain it will develop its own global brand name companies, fostering innovation and growth.” (Business Monitor International 2011)

However, in my opinion, Chinese banks will not be strong players in global markets, at least in the medium term, due to the lack of financial development (see Institutional voids on p.25) and the risky potential scenarios that will jeopardize any expansion (see next section).

Using the ADDING methodology (Ghemawat 2007) this report will show that the best places to go global to add volume (high growth potential and low leverage), would be India, Indonesia and China (which lessens the need of China’s banks to expand since they have a rich market at home).

Furthermore, the evidence confirms (see p.42) that, at least at the current level of development, China is unable to go global except for timid attempts. It has been said that a major advantage of Chinese companies has been a lack of ancient hostility (a kind of historical neutrality that allows Chinese firms to be welcomed where western powers have problems. Moreover, the argument is that in this way, as well as in other industries (construction or resources), banking will pursue global expansion. However, the industries shown as examples are currently suffering problematic situations as Chinese companies try to use their homeland institutional voids in the countries into which they are expanding (corruption, cost saving - low quality).

However, the report will show that developed markets like USA are becoming more open to China’s firms and this will constitute a key variable to follow because it will open the doors as is the case of ICBC (a major Chinese bank).

4.1 SCENARIOS TO CONSIDER

In addition, China’s banks would have to deal with the current risk of the global trends in banking (see details in the previous analysis on p. 23) that would trigger potential scenarios in the future of the banking industry. For instance, analysts (Global Commercial Banking Outlook 2010) foresee important global risks in the banking industry in the short term:

- The potential for a major internal dislocation in the Eurozone, as shown by the crisis in Greece;
- The increasing risk of a property-driven asset price meltdown in China;
- The uncertainty over greater banking sector regulation by governments worldwide.
- A global banking industry recovering from the crisis of 2008 fearing an economic slowdown in the developed world but expecting a better performance in the emerging markets.
- An increased tightening in regulation
- A surge in asset prices in the Asian region

4.2 GLOBALIZE FOR ADDING VOLUME: WHERE?

In the specific case of China, to evaluate where would be the next step in order to globalize China's banks brands, we could take a look at the Asian region as the closer candidates in terms of CAGE distances. According to some studies (Asia Banking Sector Outlook Q2 2011) the perspectives of growth for the region in the banking sector are:

Banks in the Asia Pacific region are generally well-positioned in 2011, and we believe that loan growth potential is highest in Indonesia and India. On the downside, surging capital inflows have led to a sharp spike in asset prices. We believe that a disorderly unwinding of assets (especially property) poses the largest risk to banks in the region.

After a strong year in 2010, Asia's banking sector remains sound. On balance, we prefer markets with strong domestic consumer demand (leading to higher credit growth and with less downside risks from external factors), low loan-to-deposit ratios (LDRs, to allow comfortable expansion of credit without adding stress to the financial system) and less exposure to risks posed by surging capital inflows. We have identified India and Indonesia to be in a relatively sanguine position with strong growth potential. Amongst the markets we do not like, we flag up Australia and Vietnam to potentially face systemic risks. (p.20)

In specific, looking for the countries with the most growth potential in the region a study considers India, China and Indonesia as the most desirable locations (Asia Banking Sector Outlook Q2 2011):

"In order to assess credit growth potential, we have to examine the economies that we are more bullish on over the medium term. Unsurprisingly, India, China and Indonesia lead the pack in our forecast for real GDP growth, projected to reach 8.1%, 7.5% (with upside risks) and 5.9% respectively in 2011. For India and Indonesia, we like the consumer story over the longer term and also believe that investment growth will remain robust, both of which are highly positive for credit growth." (Asia Banking Sector Outlook Q2 2011)

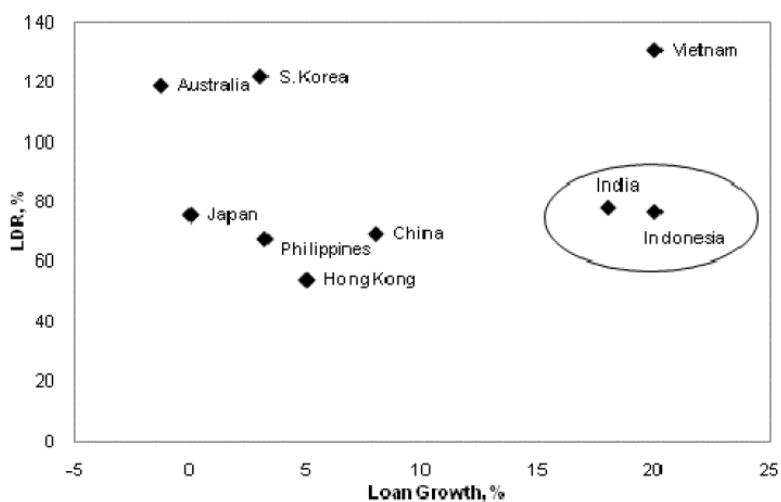
"(...) Within the region, Australia and Japan stand out as two economies with weak growth potential in 2011, at 2.4% and 0.7% respectively. In Australia's case, we believe that the economy will be hit by a correction in real estate prices. Regarding Japan, recent indicators all point to an economic slowdown (possibly even a technical recession) in the coming quarters. Accordingly, we are projecting loan growth to remain flat in Japan and to register a contraction of 1.3% in Australia in 2011." (Asia Banking Sector Outlook Q2 2011)

Specifically, if we look at countries with a lower leverage in the region, to identify India and Indonesia as the countries that could expand most in lending terms, the study (Asia Banking Sector Outlook Q2 2011) shows (see Figure 20) that:

Since the Asian Financial Crisis in 1997/98, banks in the region have generally been prudent and avoided stacking on excessive leverage. Indeed, by our calculation, the average LDR for the Asia-Pacific region is around 84%, a very low figure compared to their European (110%), Middle Eastern (94%) and Latin American counterparts (91%). Accordingly, this implies that banks in the Asia-Pacific region will have more leeway to embark on more aggressive

lending. Notably, the two domestic-demand plays that we favour in 2011 (India and Indonesia) both have LDRs below 80%.

Figure 20. Asia Pacific – Loan-to-deposit Ratio and Loan Growth Projection For 2011. Source: (Asia Banking Sector Outlook Q2 2011)



4.3 CURRENT GLOBAL STATUS OF CHINA'S BANKS

It has been said that “Chinese banks are not about to conquer the world. ICBC, which has the most expansive instincts, has made a few small acquisitions in Asia and is expanding its network branches elsewhere but remains an overwhelmingly domestic outfit.” (The Economist 29 January 2011)

Currently there has been a very limited amount of Chinese banking investment outside China. For instance, according to a study (Allen, Qian & Qian 2005):

China’s banking sector also has a limited amount of investment overseas. According to the Almanac of China’s Banking and Finance (1996-2003), at the end of 2002, all of China’s commercial banks (state-owned and non-state owned) have around 670 foreign branches, holding a total amount of US\$160 billion assets and \$156 billion liabilities; more than 90% of these branches and their assets and liabilities belong to the ‘Big Four’ state-owned banks. The entire banking system (including all non-bank financial intermediaries) has net assets (total assets minus liabilities) overseas in the amount of US\$380 billion. Finally, there are currently 111 Chinese firms listed on exchanges overseas: 108 in the HKSE, 13 in the U.S. (NYSE and NASDAQ), 3 in the U.K., and 2 in Singapore.

4.4 ADVANTAGES/DISADVANTAGES OF CHINA'S BANKS GOING GLOBAL IN EMERGING MARKETS

The experiments of Chinese brands expansion in developing countries have brought to light a “competitive advantage that is rare among economic powers... : a lack of ancient hostility. In the past decade Chinese investors have been welcomed ... in places where Western colonial powers once behaved and their descendants sometimes arouse suspicion.” (The Economist 23 April 2011)

However, Chinese investors are carrying their institutional voids and ruining the advantages. For instance in Africa complaints are that “Chinese companies get preferential loans, African businesses struggle to compete. Roads and hospitals built by Chinese are often faulty, not least because they bribe local officials and inspectors.”

Although those investments are not in banking but mostly dedicated to securing resources, they are provoking, for instance, that the Chinese be banned from selling in Tanzania. This effect is also surfacing in Poland “where a Chinese construction firm had an ear bashing bidding for a Polish motorway contract.” (The Economist 23 April 2011)

4.5 ADVANTAGES/DISADVANTAGES OF GOING GLOBAL IN DEVELOPED MARKETS

A hint of what it would mean for China to enter developed markets could be seen in a recent article (The Economist 29 January 2011): “an agreement by ICBC (the world's biggest by value) to buy 80% of the Bank of East Asia's small retail branch network in New York and California.”

This deal would be “significant because for the first time a Chinese mainland bank would have activities operating under America's regulatory framework.” In addition, this could mean (if it is approved) that American regulators would endorse the soundness of China's government-controlled and politically directed banking system,” which has been a barrier to Chinese banks expanding in America.

However, the same article states “public comments are being minimized to avoid inflaming popular and political passions... or generate a firestorm of controversy.”

BIBLIOGRAPHY

Allen, F., Qian, J. & Qian, M., 2005. China's Financial System: Past, Present, and Future. *Working Papers -- Financial Institutions Center at The Wharton School*.

Anon., 2010. Briefing China's Labour market. *The Economist*, 31 July. p.48.

Anon., 2010. China's financial system: Look again. *The Economist*, 11 December. p.105.

Anon., 2010. Global Commercial Banking Outlook. *Turkey Commercial Banking Report Q3 2010*, p. Business Monitor International.

Anon., 2011. Africa and China: Rumble in the jungle. *The Economist*, 23 April. p.13.

Anon., 2011. China's shadow-banking system: Trust belt. *The Economist*, 12 February. p.84.

Anon., 2011. Chinese banks in America: Hu's coup. *The Economist*, 29 January. p.74.

Anon., Q2 2011. Asia Banking Sector Outlook. *Japan Commercial Banking Report*.

Baron, D.P., 1995. Integrated strategy: market and nonmarket components||. *California Management Review*, 37(2), pp.47-65.

Business Monitor International, 2011. ISSN: 1747-8537 *China Commercial Banking Report Q2 2011*.

Eoyang, C., Lui, J. & Koul, S., Junio 2010. *Shanghai in 2020: Asia's Financial Centre*. Goldman Sachs Global Economics.

Ghemawat, P., 2007. *Redefining Global Strategy*. Boston: Harvard Business School.

Khanna, T., Palepu, K.G. & Sinha, J., 2005. Strategies that Fit Emerging Markets. *Harvard Business Review*.

The Economist, 2009. Peak Labour. *The world in 2010*, p.80.

The economist, 2011. China's Banks: Cognitive dissonance. *The Economist*, 5 March. p.80.

Werner, M. & Chung, A., 2010. *Chinese Banking: A Primer on the Market*. White book. Bernstein Research.