China's Banks a New Frontier for Global Finance

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By C.P Chandrasekhar

[C.P. CHANDRASEKHAR's article on the rush of foreign financial institutions and investment funds to buy a share of China's big banks is fascinating and. Chandrasekar describes a frenzy to buy into deals that so lack transparency as to be - if you will - opaquely translucent. No matter. As is so common in our bubble-prone era as to pass without notice, the mere scent of speculative profits is enough to set billions of dollars flying across globalized borders. Never mind the proud claim that in the industrialized states no deal is ever done without complete transparency. But with the Renminbi likely to rise, and with the world's most dynamic economy, investors have rushed in blithely and blindly with billions.

What is unclear to Chandrasekar is why the Chinese government would be encouraging equity investment into its banks. Not only did it just finish bailing them out from a frightful overhang of very bad loans, but it seems likely to want to maintain control over its financial institutions. As Chandrasekar delicately puts it, there are inherent conflicts between "international private concerns" and "national social concerns," and it is unclear how the Chinese government expects to balance these.

What the article does not mention, however, is the recent failure of the Chinese state-owned CNOOC to buy the U.S. oil firm Unocal, even though it offered top dollar for it. That bid elicited a firestorm of opposition from within the United States, and appears to have led Chinese government officials to advise the country's business leaders to temporarily slacken off foreign merger and acquisition activities, at least in the U.S.. Perhaps this experience has led the Chinese state to risk a degree of control over its levers in the financial sector in a bid to encourage Washington to step back from its protectionist activities. That is, allowing foreign direct investment in a sector that has been off limits to international capital could help tip the balance of interests overseas to ensure a favourable reception for future Chinese purchases in energy and other advanced sectors, and undercut pressures to limit imports of Chinese manufactures.

What is also not mentioned in the article is participation by Japanese banks and investment funds in these deals. If there is indeed no participation, can it be indicative of how far Japanese banks have fallen from grace with Chinese authorities? It could be, one imagines, an indication of lingering animosity towards Japan per se in the wake of PM Koizumi's repeated visits to Yasukuni Shrine and territorial conflicts in the East China sea. If speculation is correct about a new Koizumi visit to Yasukuni in the wake of his landslide win in the September 11 elections, it is a good bet that Japanese money won't be going into China's banks any time soon. Or is this an indication of Japanese financial prudence, holding back from placing billions in a black box? Japan Focus.]Foreign investors are understandably showing an increasing interest in Chinese banks. But it is not clear why the Chinese government is courting the dangers associated with their entry.The Bank of China branch in central Beijing.

The Bank of China, Hong Kong

Until recently, China's banks were described in terms that made them global outcasts. They were not seen as banks that mobilised savings for investment, but agencies for channelling state subsidies (named loans) to state-owned enterprises with soft budget constraints. They were perceived as being burdened with huge non-performing assets, which were a legacy of their position as an instrument of the state, rather than commercial ventures. And they were considered to be corruption-ridden. Unless they were restructured and recapitalised with substantial infusion of funds, their closure was considered a serious possibility.

Such assessments were particularly disturbing because the `big four' - Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China, which are wholly state-owned - dominated the banking sector, accounting for an overwhelming share of assets. Failure of any of them could have devastating consequences for the financial sector as a whole. But failure, most observers agreed, was a remote possibility, given the strength and control exerted by the Chinese government. What seemed more likely is that foreign players, who were to be provided a greater foothold in the Chinese banking market as part of the conditions for China's access to the World Trade Organisation (WTO), which require a complete opening up of the banking sector to foreign firms by 2006, were seen as unlikely to be interested in acquiring a stake in these banks even if offered a deal.

All that has changed considerably in recent months, but especially during August which saw the completion or announcement of three major acquisitions of equity in Chinese banks. On August 19, the Royal Bank of Scotland (RBS), leading a consortium that included investment banker Merrill Lynch and Hong Kong billionaire Li Ka-shing, acquired a 19.9 per cent stake in Bank of China, the second largest in the country in terms of assets, with an investment estimated at $2.5 billion. Soon thereafter, Temasek Holdings, Singapore's state-owned investment company that is responsible for state equity investment in the country, announced that it would acquire around 10 per cent of equity stake in Bank of China. If this is in addition to the acquisition by RBS, foreign ownership in Bank of China would amount to an unprecedented proportion of nearly 30 per cent. However, full details are still awaited.

As if this huge acquisition in China's second largest bank was not enough, on August 30, a second consortium consisting of Goldman Sachs, American Express and Allianz (of Germany), among others, signed a preliminary agreement for acquisition of a 10 per cent stake in China's largest bank, Industrial and Commercial Bank of China, for an estimated sum of more than $3 billion.

Add these to the acquisition by foreigners of two chunks of equity in China Construction Bank in the second half of June, and the tendency towards privatisation of the core of China's banking sector (except, of course, for the Agricultural Bank of China, which is unlikely to find willing buyers) is clearly established. On June 16, Bank of America invested a 9 per cent stake in China Construction Bank for $2.5 billion, with the option to raise this stake to 19.9 per cent at a later date. Days later, on July 1, Temasek announced the acquisition of an estimated 10 per cent stake in China Construction Bank for $2.4 billion. This, together with the more recent acquisition of equity in the Bank of China, makes Temasek the biggest foreign player in China's banking sector. Overall, The Wall Street Journal estimates that foreign investors have pumped in more than $15 billion into the Chinese banking industry since June.

WHY has there been such a sudden rush of interest in a sector that was not considered a worthwhile investment until recently? Needless to say, there have been a number of developments that have been occurring in the background that warrant a change in mindset. First, partly in preparation for the full opening up of local currency banking to foreign players by 2006, the Chinese government has been recapitalising its banks. The government is estimated to have pumped as much as $60 billion into the three biggest banks to write off loans that were unlikely to be repaid. As a result, official figures show that the proportion of non-performing loans fell to 13.2 per cent at the end of 2004, compared with 18 per cent the year before. Industrial and Commercial Bank of China, which received the largest share of recaptalisation funds from the government, claims to have slashed non-performing loans to 4.5 per cent of advances as compared with 19 per cent last year. Though these figures are not accepted by many, substantial recapitalisation has occurred. Second, the governance structure of banks has been modified in keeping with market requirements, with credit-risk assessment systems, audit committees and boards of directors. Further, efforts are underway to reduce substantially "overmanning". And, third, penal actions have been initiated against corrupt senior bankers, conveying the message that corruption will not be tolerated, For example, the extreme penalty of a death sentence, which had been suspended, was imposed on the head of Bank of China's Hong Kong unit in August on grounds of embezzlement. Earlier in March, the Chairman of China Construction Bank was forced to resign following allegations of corruption. Bank of China has reportedly "tried and penalised" at least 50,000 workers for fraud.

THESE developments are being used to justify why yesterday's outcasts have become today's favourites. But, they still do not explain why foreign players are interested in acquiring minority stakes in the big banks rather than set up operations on their own. As the WTO deadline of 2006 approaches for providing foreign banks full national treatment in local banking, what was expected was that there would be increased interest in increasing their presence through their own subsidiaries and joint ventures. Rather it appears that foreign interest in Chinese banking has gone through a two-step process. To start, with foreign banks seemed to be interested in establishing a Chinese presence through subsidiaries or joint ventures with smaller banks. According to China Banking Regulatory Commission (CBRC) statistics, foreign banks had set up 204 operational entities in China by the end of October 2004, with total assets amounting to 553.4 billion yuan ($66.7 billion). By that time, sometimes ahead of WTO accession requirements, some 105 foreign banks had won renminbi (RMB) licences, 61 of which have been allowed to provide renminbi services to Chinese enterprises. But their overall presence is indeed limited. They account for only 1.8 per cent of all banking assets in China, though they have managed to secure 18 per cent share of the foreign currency lending market.

Foreign banks also acquired stakes in smaller commercial banks. For example, Shenzhen Development Bank announced in October 2002 that Newbridge Capital Inc. had acquired a stake of 18.02 per cent in the bank through an investment of new capital and the acquisition of existing holdings from state shareholders. Citigroup announced on January 2, 2003, that it would purchase a 5 per cent stake in Shanghai Pudong Development Bank. Ing Group acquired a 19.9 per cent stake in Bank of Beijing in March 2005. And, Commonwealth Bank of Australia bought a 19.9 per cent stake in Hangzhou City Commercial Bank in April 2005. Instances of this kind have been proliferating.

However, what the current spate of acquisition suggests is that foreign banks are graduating out of a complex process of growth involving building a network based on making large investments, negotiating the regulatory framework and competing with the big four banks. The Chinese government's growing willingness to permit sale of minority equity blocs in the big four banks as well as the promise of profit from the large network these banks control in an economy that continues to boom, seems to have persuaded them to settle for an initial minority stake. Competition between foreign banks to acquire a share in the credit card, consumer credit and mortgage loan business, which is expected to boom in the coming years, has obviously changed their mindset.

But that is not all. These investments have a strong speculative component. There are many who are speculating on the real possibility that the value of bank shares would appreciate significantly in the run-up to their being listed on stockmarkets at different points of time over the next two years. This clearly explains the interest of investment bankers like Merrill Lynch and Goldman Sachs who are unlikely to be interested in contributing to the management of large banking networks in a spiralling market. It also possibly explains the interest of Temasek Holdings in making Chinese bank equity a significant part of its $54 billion investment portfolio.

The recent decision of the Chinese government to begin the process of unpegging the RMB from the dollar must be aggravating this speculative tendency. China's massive foreign reserves, unprecedented export success and attraction of foreign investors suggest that the RMB would only rise if the government increased the band within which it can fluctuate. A purchase of equity today not only promises to offer large profits when these banks are listed, because of appreciation of the RMB value of such equity, but substantial gains from currency appreciation.

Thus while foreign investor interest in the Chinese banking frontier is understandable, what is unclear is the motivation for the Chinese government's decision to divest large chunks of equity in the big four banks. Given China's ambiguous guideline on foreign equity caps, the extent of such divestment is clearly being decided on a case-by-case basis. And given the most recent trends it appears that the aggregate 25 per cent ceiling and limit of 20 per cent for ownership by a single investor may be reached. However, having recapitalised banks with local resources and restructured them, the government is unlikely to move to a situation where it loses control.

It could be argued that a foreign presence could ensure managerial inputs needed for new markets such as the credit card, automobile finance, consumer credit and mortgage markets into which these banks are diversifying. But even if such expertise is seen as not easily developed or hired, the focus must be on acquiring appropriate partners. The indications that speculative motives, rather than purely long-run interest are involved in the current spate of acquisitions suggest that this is not the emphasis. Given that, the reason why the Chinese government is courting the dangers associated with the entry of players with international private concerns that are sharply at variance with national social concerns, which the banking system must take account of, remains unclear.

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