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**The Strategic Value of Investments  
in Chinese Banks by Foreign Fi-  
nancial Institutions**

by Horst Löchel and Florian Pecher

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Sonnemannstr. 9–11 60314 Frankfurt an Main, Germany  
Phone: +49 (0) 69 154 008 0 Fax: +49 (0) 69 154 008 728  
Internet: [www.frankfurt-school.de](http://www.frankfurt-school.de)

## Abstract

China's banking market is one of the most attractive investment targets for financial institutions worldwide especially since the opening up of the market in December 2006. Based on interviews with experts this paper analyses the question of benefits and risks of foreign direct investments into Chinese banks. As a result it can be shown that there is no unique answer. Rather it depends on the strategic goals of the foreign institute itself. The paper recommends certain strategies based on the answers of the experts.

Key words: China's banking market, FDI, M&A

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### Contact:

Horst Löchel, Prof. Dr.  
Chairman and Vice-President, Shanghai International  
Banking and Finance Institute (SIBFI)  
Prof. of Economics, Frankfurt School of Finance &  
Management  
Email: horst.loechel@sibfi.com

Florian Pecher  
E-Mail: florian.pecher@gmx.net

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## List of abbreviations

ABC	Agricultural Bank of China
ADB	Asian Development Bank
ANZ	Australia and New Zealand Banking Group
bn	Billion
BOC	Bank of China
BoCom	Bank of Communications
CBA	Commonwealth Bank of Australia
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CCB (2)	City Commercial Bank
DEG	Deutsche Investitions- und Entwicklungsgesellschaft mbH
Dep.	Depends
ICBC	Industrial and Commercial Bank of China
IFC	International Finance Corporation
JSCB	Joint-stock commercial bank
m	Million
M&A	Mergers & Acquisitions
n/a	Not available
NPL	Non-performing loan
OCBC	Oversea-Chinese Banking Corporation
p.a.	Per annum
SIDT	Sparkassen International Development Trust
SME	Small and medium sized enterprises
SOCB	State-owned commercial bank
WTO	World Trade Organization

## 1 Introduction - Executive Summary

The following working paper is the result of a Master-Thesis, written in the first half of 2007 at the Frankfurt School of Finance & Management. The thesis was inspired by the seminar *Banking and Finance in China*, which is an integrated part of the Master of Science program at Frankfurt School and the book *The Future of Banking in China* published at the end of 2006<sup>1</sup>. The expert interviews in China were conducted in cooperation with the *Shanghai International Banking and Finance Institute (SIBFI)*, the bank training institute of Frankfurt School in China since 2004.

The paper raises the question of the strategic value of investments of foreign banks into China's banking sector. The importance of the question is evident, given the fact that China is not only the fastest growing economy on earth but also disposes of the most expanding and hence attractive banking market worldwide. Foreign direct investments into Chinese banks, for example, were four times higher in 2006, which ended a five year transition period opening up the banking market, than in the year 2001, when China joined the WTO<sup>2</sup>.

The paper is highly empirically. It is based on interviews with bankers and experts who are familiar with the Chinese market and the investments of foreign banks. The number of interviews is limited but nevertheless significant given the high degree of the interviewees' expertise on the one side and the narrow market on the other.

The interviews focused on three areas:

- Principle considerations to invest into Chinese banks
- Specific investment considerations
- Potential pitfalls of these investments

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<sup>1</sup> Löchel, Horst, Zhao, Xiaojun (2006).

<sup>2</sup> CBRC (Ed.) (2007).

Regarding the question whether it makes in principle sense to invest into Chinese banks, the answers are clearly in favor for retail banking. For both corporate and retail banking the concern still remains how to become influential in the investment target given the well-known thresholds for foreign investments into Chinese banks<sup>3</sup>. Last but not least, it is worthwhile to note that no single expert is expecting short term financial gains and even for the long run only a short majority of 53% are expecting profits.

Also the specific investment goals are clearly in favor for retail banking given the fact that the access to the branch network and the client base are seen as the by far most important investment purposes of foreign investors. It is interesting to note, that most of the experts see the joint-stock banks as the most valuable targets whereas the big state owned banks are even behind the City Commercial Banks. This reflects the concerns about the limited decision making power in such big tankers. It should be noted in this context that China's postal bank at that time was not part of the questionnaire.

The answers to the question of the pitfalls of foreign investment into Chinese banks reflect the regulatory environment in China. Most of the experts perceive the lack of control over the investment target in conjunction with the comparatively low standards of corporate governance in Chinese banks as the most pressing issue. Furthermore, cultural differences including language are other hurdles of a successful management of the investment.

Overall the results of the expert interviews show that there is no unique answer about the strategic value of foreign investments into Chinese banks. Rather it depends on the strategy of the foreign bank itself. A foreign financial institute, for example, which wants to enter the Chinese retail market clearly needs a strategic, domestic partner in China given the sheer size of the country and the lack of an own client base. However, which kind of partnership is chosen and which partner is selected depends on the risk appetite of the foreign institute and on how ambitious its China strategy is. Our study indicates that investing into China's joint stock banks is strategically superior to investing into the big state owned banks due to the higher degree of influence which can be gained over these smaller targets.

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<sup>3</sup> CBRC (2003).

## **2 Investments in Chinese banks as a strategic option of market exploration**

### **2.1 Research methodology**

#### **2.1.1 Type of survey and data sources**

The following analysis of the strategic value of investments in Chinese banks is based on interviews with senior executives of foreign banks, investment bankers advising on M&A transactions as well as strategy consultants with a focus on the Chinese financial services sector. Foreign bank executives were interviewed due to their immediate relation to the research topic. They operate in the Chinese banking market on a daily basis and are therefore familiar with the market forces as well as the growth options available to foreign banks. Many of them personally dealt with the question whether their bank should invest in a Chinese player either directly or indirectly before. Investment bankers and strategy consultants were interviewed, because they are able to draw from a broad range of advisory experiences in the industry and region. They are hence more detached from any individual player's specific situation in China and are therefore able to adopt a neutral but yet well informed perspective.

Most interviews were conducted in the form of face to face meetings with the interviewees at their offices in Hong Kong or Shanghai during May and June 2007. Whenever time constraints did not allow for personal meetings, interviews were conducted over the telephone. In very rare exceptions, when respondents' schedules neither permitted personal nor telephone interviews, they were sent a research questionnaire via e-mail and responded in the same way. All interviews were standardized open-ended interviews and based on a research questionnaire containing 6 questions<sup>4</sup>. These questions explored whether strategic investments in Chinese banks generally make sense, where their strategic value is to be found and which pitfalls to be aware of in order to realize their inherent value. The interviews lasted in between 15 to 45 minutes with the average duration having been approximately 30 minutes. The questionnaire itself was designed so that it could be adequately answered within 15 minutes.

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<sup>4</sup> To view the research questionnaire please refer to Appendix 1.

Respondents were encouraged to provide examples, share personal experiences and elaborate further on specific topics whenever time permitted this though. This explains the noteworthy spread in duration between the longest and shortest interviews. The reason for choosing this approach was, that it allowed for data to be collected in a structured way while at the same time providing enough flexibility for interviewees to share valuable insights not specifically asked for.

### **2.1.2 Data volume and quality**

The total number of interviews conducted amounts to 21. Of the respondents, 9 were based in Hong Kong, 11 in Shanghai and 1 in Beijing. The majority of all interviews, i.e. 14 were face to face meetings, 5 were telephone interviews and only 2 respondents submitted their answers via e-mail. There have been 11 foreign bank executives, 5 investment bankers and 5 strategy consultants interviewed<sup>5</sup>. All interviewees were either senior professionals or held senior management positions at their respective firms. They furthermore possessed longstanding experience in the industry and region. Against this background all interviewees were fully qualified to participate in the survey.

Limitations on the data quality arise from several factors. First of all, it was not possible to collect all data with one uniform method. Even though questions were asked in the exact same way in face to face meetings, over the telephone and via e-mail, the different methods of data collection might have influenced the way interviewees responded to some extent. Secondly, respondents were asked to share their personal opinions and views. Although argued on the grounds of observable facts and logic, the statements made are hence subjective in nature. A third limitation arises from the low number of interviews conducted. The survey results can therefore not be considered as universally valid or fully representative. It is however possible to recognize consistent elements and clear trends within the survey results, which allow for qualitative interpretations. Considering the seniority of interviewees as well as their extensive experience in the Chinese banking market, it can be assumed that their statements come quite close to reflecting the actual market conditions. The inclusion of investment bankers and strategy consultants, who are detached from and therefore not influenced by any specific foreign

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<sup>5</sup> For a complete list of survey participants please refer to Appendix 2.

bank's strategic setup, furthermore helps in presenting a more comprehensive and balanced picture.

### **2.1.3 Method of result presentation**

Results will be presented using descriptive data analysis. Every category, to which certain parts of the questionnaire were assigned to, will commence with a brief presentation of the respective key findings in aggregate form. This will be followed by a more detailed description of the qualitative answers collected. In a third step, the results will then be matched with complementary information and discussed further.

## **2.2 Investments in Chinese banks – a question of principle**

Before going into a more specific assessment of strategic value<sup>6</sup>, it is essential to evaluate whether acquisitions of minority stakes in Chinese banks generally make sense from a foreign financial institution's point of view. To provide an answer to this question, three aspects will be taken into consideration. First of all, it will be determined if the acquisition of a mere minority stake itself is an adequate tool of exploring the Chinese market. Due to differences in the underlying market dynamics, this shall be done separately for corporate and retail banking. It shall secondly be elicited whether it is expected that foreign banks will be given a chance to upgrade their investments to majority stakes in the near future (1-2 years). The relevance of this is that if a major regulatory turning point would be anticipated, investments would not be primarily made because of making sense under the prevailing circumstances, but rather in an effort to position oneself in the best possible way to capitalize on the changes ahead. Thirdly, the financial perspective should not be neglected completely. It will be investigated whether investments in Chinese banks are considered to be financially attractive.

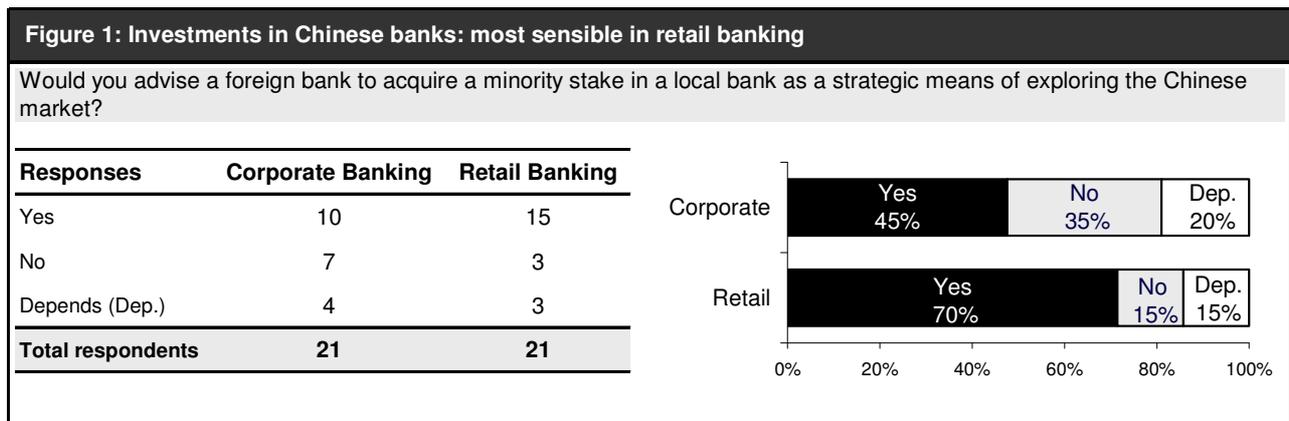
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<sup>6</sup> For a discussion on the nature of strategy please refer to Porter, Michael E. (1996), which also includes a definition of strategy on p. 68.

## 2.2.1 Presentation of survey results

### 2.2.1.1 Investments in Chinese banks not per se advisable

At the outset, interviewees were asked, whether they would advise a foreign bank to acquire a minority stake in a local (Chinese) bank as a strategic means of exploring the Chinese market. They were furthermore requested to differentiate between corporate and retail banking in their answer. Figure 1 (below) presents an overview of the answers obtained.



Source: own illustration and calculations

As far as corporate banking is concerned, most respondents made the general remark that the currently permitted business scope and available organic growth options (including local incorporation) would be sufficient for foreign banks to serve their captive audience of multinational clients. 45% of the interviewees find investments in Chinese banks however definitely advisable to tap the domestic Chinese corporate banking market. 35% would not suggest acquiring a minority stake in a local bank at all and 20% believe that there can be no clear answer to this question as it would always depend on the individual case.

Interviewees voting in favor of investments in Chinese banks by the majority named access to the target's existing infrastructure (branch network), client base and the learning experience associated with the investment as the key investment considerations. Since these strategic benefits were discussed separately and in more detail at a later stage of the interviews, they will not be elaborated on at this point. A more in-depth examination of these benefits will follow in section 2.3.1.1.

Survey participants voting against investments in Chinese banks emphasized, that overseas financial institutions would be considerably more advanced than their Chinese counterparts in terms of service quality and product offering and that a nationwide presence would not be necessary to capture an adequate share of the market. They therefore saw them well positioned to achieve growth in corporate banking without falling back on acquisitions. One respondent also pointed out, that many leading Chinese and foreign enterprises possess centralized financing functions in Beijing or Shanghai and make use of domestic cash pooling and electronic banking. They could therefore easily be served by foreign banks through their own branches in these cities. An investment in a local player would therefore not yield noteworthy added value.

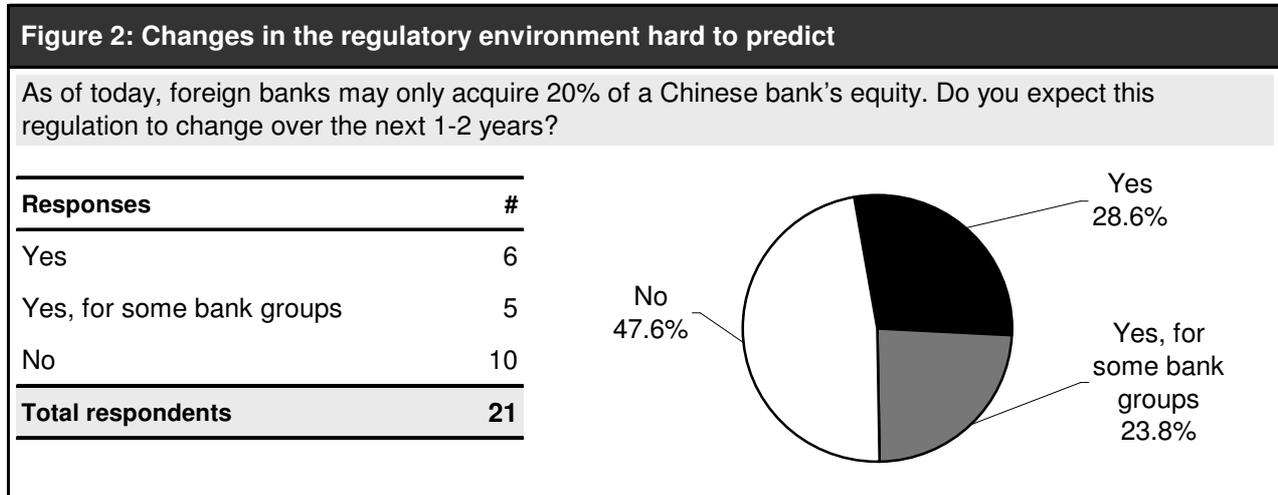
Turning to the retail banking market, 70% of the interviewees would advise foreign financial institutions to invest in a local bank, only 15% would not do so and 15% would make the decision completely dependent on the individual players' profiles. The majority of respondents argued that no international bank has so far been able to build a branch network big enough to tap the retail banking market at a large scale. Lacking a noteworthy distribution platform themselves, foreign players would be left with little choice but to make Chinese banks' distribution channels accessible to them via equity investments. Respondents also mentioned access to a broad client base and the associated learning experience as key investment considerations. These strategic benefits will also be examined in more detail in section 2.3.1.1.

Interviewees who argued against acquisitions of equity stakes to explore the Chinese retail banking market either believe that there would be more creative ways to capitalize on the strengths of Chinese banks (e.g. non-equity based strategic alliances) or are concerned with the fact that an investor as minority shareholder would have very little to no control over the business development.

#### *2.2.1.2 Uncertainty about the regulatory environment prevails*

This last concern directly leads to the next question: will foreign strategic investors be able to upgrade their equity shares to majority stakes and thereby gain management control over their

targets in the near future? Figure 2 (below) presents an overview of the answers obtained to this question.



Source: own illustration and calculations

28.6% of all respondents expect the 20% threshold to change over the next 1-2 years, 23.8% suppose that this will however be limited to some groups of banks and 47.6% see no regulatory change ahead in the near-term. The participants anticipating the 20% threshold to be increased mostly do not foresee a sudden change allowing foreign investors to gain 100% equity control of Chinese banks per se. They rather expect a gradual erosion to take place over time.

Those respondents foreseeing a lifting of the 20% threshold restricted to some bank groups only, unanimously argued that the Chinese government would for the sake of maintaining macroeconomic control not allow foreign investors to take majority stakes in the big four state-owned commercial banks. The respondents again expect a gradual erosion of the threshold rather than an abrupt change of rules to occur. Some of them referred to the Chinese government's overall reform strategy, which would be characterized by trying out new things first at a smaller scale, in special economic zones for instance, before implementing them nationwide. They therefore expect the government to allow overseas banks to purchase majority stakes in a few selected targets first and if this works out well, to generally permit bigger stakes to be held in joint-stock and city commercial banks. One foreign bank executive also made the restriction, that the threshold might only be increased to a single foreign investor

holding 49% of a Chinese bank's equity at most, which would still leave domestic shareholders in control of the respective credit institution.

Almost half of all interviewees do not expect the current 20% threshold to be increased in the near-term. One frequently made point was, that this would not yield noteworthy added value to the Chinese side. By attracting foreign investors, the Chinese government intended to bring in their international expertise and capital to boost the competitiveness of local banks. Experience had shown that both goals could be satisfactorily achieved with the current regulations in place. Therefore it would be hard to see, why China should be keen on changing them. Many respondents furthermore referred to an ongoing debate in China about the endangerment of the nation's economic security through foreign investors gaining too much influence and power over the Chinese economy. Against the background of this public sentiment as well as the prevailing excess liquidity in the Chinese banking system, the PRC's government would have stronger incentives to leave the regulation unchanged rather than modifying it.

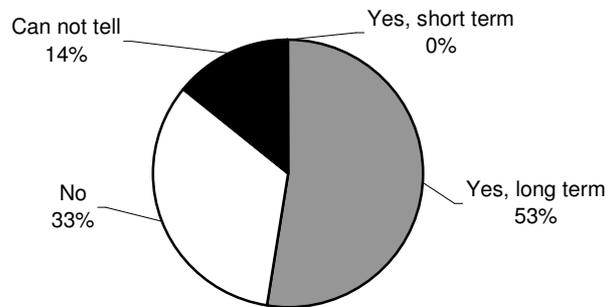
#### *2.2.1.3 No speculative short-term gains possible*

53% of all respondents consider acquisitions of minority stakes in Chinese banks to be an attractive long-term financial investment, 33% oppose this view and 14% would not commit themselves to a clear-cut answer. No single respondent believes that such investments would be financially attractive over the short term. Figure 3 (below) visualizes the answers obtained.

**Figure 3: Equity stakes in Chinese banks - definitely no short-term investment**

Given the sector's current and expected future development, would you describe investments in Chinese banks as financially attractive at this stage?

Responses	#
Yes, short term	0
Yes, long term	11
No	7
Can not tell	3
<b>Total respondents</b>	<b>21</b>



Source: own illustration and calculations

Respondents considering acquisitions of equity stakes in Chinese banks as long-term financially attractive, mostly pointed to the extremely favorable outlook on the future of the Chinese banking industry and therefore perceive Chinese banks' current valuation levels as still being low. According to most participants, the biggest financial gains could be made by investing into a Chinese player before it goes public. The value of the investment could easily be doubled or even tripled this way. It was however frequently noted, that foreign banks would usually be obliged to observe a three-year holding period, during which they were not permitted to realize financial gains. Speculative short term investments would therefore be per se not possible.

Interviewees negating the financial attractiveness of equity investments in Chinese banks mostly argued that this window of opportunity would be already gone. After the first Chinese banks went public, their share prices sky-rocketed and the resulting spill-over effects would lead to attractive targets being overpriced by today. According to these participants, the rationale behind investing in Chinese banks should definitely be strategic and not financial.

## 2.2.2 Discussion of key findings

### 2.2.2.1 Review of organic growth as viable alternative

The above presented survey results suggest, that investments in Chinese banks are more beneficial as part of a retail banking than of a corporate banking strategy. According to most interviewees, gaining access to a local player's distribution network<sup>7</sup> is the main attraction of investments in both cases. This seems to be more crucial for success in retail than in corporate banking. Client proximity in the form of physical branch networks is still a key decision criterion for Chinese consumers in selecting a banking relationship and therefore absolutely critical for banks to succeed in the retail banking market<sup>8</sup>. As respondents voiced concerns about the foreign investor not being able to exercise adequate managerial control over the target, it should be reviewed, whether organic growth, allowing for full managerial control, would be a viable alternative.

By today no single foreign bank was able to establish a comprehensive branch network on its own in China<sup>9</sup>.

This was attributed to the regulatory environment turning the establishment of new branches by overseas market entrants into an extremely long-winded and cost intensive process<sup>10</sup>.

Furthermore the new "Regulations of the People's Republic of China on Administration of Foreign-funded Banks", which became effective in December 2006, now grant foreign banks the right to incorporate locally and thereby achieve the same regulatory status as domestic banks<sup>11</sup>. The relevance of this is that local incorporation allows foreign banks to speed up the expansion of their branch networks dramatically. It is against this background, that locally incorporated foreign banks like HSBC, Standard Chartered Bank and the Bank of East Asia have publicly announced plans to double or even triple their branch networks in Mainland

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<sup>7</sup> China CITIC Bank (Ed.) (2007), p. 56 / KPMG (Ed.) (2005), p. 7.

<sup>8</sup> Naumann, Ivo (2006), p. 123.

<sup>9</sup> CBRC (Ed.) (2007), CBRC (2007), p. 133, HSBC (2007), The Bank of East Asia (2007), Standard Chartered Bank (2007), Citi China (2007).

<sup>10</sup> Deloitte Touche Tohmatsu (Ed.) (2006), p. 5, CBRC (2006), Löchel, Horst (2006), p. 36.

<sup>11</sup> CBRC (2006).

China over the next one to two years<sup>12</sup>. Subject to the condition of local incorporation, organic growth therefore could indeed be an attractive alternative to investments in Chinese banks.

On the other side it should not be forgotten that even leading foreign banks' branch networks will remain inferior to those of their Chinese competitors for an indefinite time. This can be vividly illustrated through the case of HSBC, which currently operates the largest foreign branch network in Mainland China. Pretending in a highly ambitious scenario, that HSBC manages to double the number of its outlets (currently 40) over the next year and then consistently keeps adding 40 new branches per year, it would still take it around 10 years to build up a presence comparable to that of an average joint-stock commercial bank<sup>13</sup>. Closing the gap to the country's dominant big four state-owned commercial banks with over 10,000 branches each or even the much smaller Bank of Communications with its 2,607 branches nationwide is definitely out of reach<sup>14</sup>. This example clearly demonstrates that a sole reliance on organic growth is not suited to significantly increase the distribution power of foreign banks in China. The above sketched out scenario also assumed local incorporation, which is cost and resource intensive<sup>15</sup> and thus for many banks per se no viable option.

Even leading locally incorporated foreign players such as HSBC, Standard Chartered Bank and Citigroup complement their organic growth with strategic investments in Chinese banks as part of a diversified market development strategy<sup>16</sup>. An exception to this is only the Bank of East Asia, which so far relies on organic growth only<sup>17</sup>. This does however not mean that the Bank of East Asia would not consider investments in Chinese banks. According to the M&A deal database ZEPHYR, the bank has previously been in negotiations with Shenzhen Commercial Bank (2003, 20% stake), Guangzhou Commercial Bank (2004, 20% stake),

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<sup>12</sup> Goldman Sachs Global Investment Research (2006), p. 5.

<sup>13</sup> Own calculation based on HSBC (2007). / China CITIC Bank (Ed.) (2007).

<sup>14</sup> China CITIC Bank (Ed.) (2007), p. 55.

<sup>15</sup> CBC Shanghai (Ed.) (2006), p. 28f.

<sup>16</sup> Löchel, Horst (2006), p. 41ff.

<sup>17</sup> The Bank of East Asia (2007b).

China Minsheng Bank (2004, unknown stake) and Dalian City Commercial Bank (2005, unknown stake). According to the database, negotiations with Guangzhou Commercial Bank are still ongoing and a successful closing of the deal was in January 2007 reported to be very likely<sup>18</sup>.

#### 2.2.2.2 *Equity control might remain unachievable*

The survey participants' opinion on whether the maximum equity stake foreign investors can acquire in Chinese banks would be increased in the near future greatly diverged. In fact, the Chinese government's position in this regard has often been unclear in recent years<sup>19</sup>. In its 2007 released "Report on the Opening-up of the Chinese Banking Sector", the CBRC stated that further opening up initiatives should follow the needs of the country's economic development and repeatedly highlighted the local incorporation oriented policy as its tool of choice to "...meet the development needs of foreign-funded banks."<sup>20</sup> From this statement, it can be concluded that the CBRC would only relax the rules on equity investments, if this was beneficial for China's economic development. It is however hard to identify any significant benefit for the Chinese government arising from allowing foreign banks to acquire bigger equity shares in domestic banks unless they are unable to increase their competitiveness by their own.

Several indicators actually suggest that the incentives to keep the 20% threshold in place outnumber those of increasing it. Firstly, there is a general debate in China about the threat of foreign-funded M&A to the country's national economic security<sup>21</sup>. Allowing foreign investors to acquire bigger or even majority stakes in Chinese banks is against this background a politically extremely sensitive issue.

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<sup>18</sup> The transaction did not close yet and there is also no updated information available.

Source: ZEPHYR database analysis.

<sup>19</sup> The Economist Intelligence Unit (Ed.) (2007), p. 25.

<sup>20</sup> CBRC (Ed.) (2007).

<sup>21</sup> Wang, Zhile (2007), p. 44ff / Bowers, Tab/ Gibb, Greg/ Wong, Jeffrey et al. (2003), p. 108.

There is secondly a recent case in which the CBRC actively intervened to protect a major bank from being eventually taken over by foreign investors. In April 2007, the CBRC's chairman Liu Mingkang announced that the country's largest joint-stock commercial bank, Bank of Communications had been reclassified as a state-owned commercial bank. He justified this step arguing on the grounds of the Chinese economy's overall stability (i.e. national economic security). When HSBC invested USD 1.75 bn in Bank of Communications, the purchase agreement included a clause allowing it to increase its 19.9% stake to 40% subject to government approval. Due to the reclassification of Bank of Communications, this clause has become effectively void by law<sup>22</sup>.

Thirdly, the prevailing excess liquidity in the banking sector is a major concern to the Chinese government. Causative for the formation of China's excess liquidity problem are the country's surging foreign reserves, which are fueled by the PRC's high trade surplus and the inflow of foreign investments<sup>23</sup>. Making regulatory changes which would most probably result in a massive additional inflow of foreign direct investments into Chinese banks would therefore be counterproductive to the government's efforts in reducing excess liquidity.

While these indicators suggest, that the 20% threshold on foreign ownership will not be lifted in the near-term, they do not rule out the possibility of foreign investors taking full managerial control of Chinese banks on a case by case basis. There are currently two examples in China, where foreign investors were able to seize management control of domestic banks while still not holding more than 20% of the respective banks' equity. In 2004, the American private equity sponsor Newbridge Capital acquired 17.9% of Shenzhen Development Bank allowing it to appoint the chairman and senior executives at the bank and thereby controlling it<sup>24</sup>. Further to that, a Citigroup led consortium acquired 85% of Guangdong Development Bank in 2006. While Citigroup gained significant influence over the target, it only holds 20% of its equity. The remainder of the consortium's 85% stake is held by domestic Chinese investors

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<sup>22</sup> Anderlini, Jamil / Thal Larsen, Peter / Böschen, Mark (2007).

<sup>23</sup> Ba, Shusong (2007), p. 15.

<sup>24</sup> International Herald Tribune (Ed.) (2006).

(China Life Insurance, Guangdong Finance Investment Holding, State Grid Corporation of China and CITIC Trust and Investment) and IBM<sup>25</sup>.

### 2.2.2.3 *Financial gains – a bet on the Chinese stock market*

More than 50% of the survey participants found investments in Chinese banks to be long-term lucrative. In fact, most investors are obliged to hold their stakes for a minimum of three years and are therefore unable to realize short-term speculative gains<sup>26</sup>. Previously conducted investments have so far performed extremely well and investors made significant paper gains. Goldman Sachs for instance invested USD 2.6 bn in ICBC in April 2006 and saw the value of its stake increase by almost USD 4 bn in October 2006 after ICBC's initial public offering<sup>27</sup>. The long-term financial attractiveness of the investment is however highly dependent on the future development of China's stock market. Given the market turbulences in the start of the year 2008 there are signs that it could become difficult to realize the expected paper gains. Furthermore, given the still unnaturally high price-earning ratios on the stock markets in Hong Kong and Shanghai even the current valuations of Chinese listed banks appear unsustainable.

The financial attractiveness of new investments in non-listed banks greatly depends on the agreed upon purchase price, which is usually determined in bilateral negotiations between buyer and seller. Should the target go public in a positive stock market environment afterwards, the investor could generate paper gains similar to the one described above<sup>28</sup>. The long-term financial attractiveness of the investment would thereby however also become dependent on the development of China's stock market.

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<sup>25</sup> ZEPHYR database analysis.

<sup>26</sup> Leigh, Lamin / Podpiera, Richard (2006), p. 7.

<sup>27</sup> Chan, Cathy / Cox, Adrian (2006).

<sup>28</sup> For a list containing equity valuation multiples of foreign investments in Chinese banks in comparison with their IPO valuations please refer to Ernst & Young (2007), p. 6.

From the above, it can be concluded, that the probability of realizing financial gains from investments in Chinese banks is directly linked to the country's stock market development. Against the background of the current market environment, it remains doubtful whether today's equity valuations are sustainable in the long-run.

## **2.3 Key investment considerations**

After having elicited whether investments in Chinese banks are generally advisable or not, the next step in establishing a sound foundation on which to verify the introductory hypothesis, that these investments yield unique strategic benefits making them indispensable for foreign banks to succeed in the Chinese banking market, is to examine which special benefits foreign financial institutions can gain through their investments. In other words, where is the unique strategic value of investing in a Chinese credit institution to be found? This question is closely interconnected with the issue of target selection and availability. The ultimate precondition to realizing a theoretically conceivable strategic benefit is obviously identifying the right target allowing for this. Both matters were addressed in the survey and the obtained results will be presented in the following section.

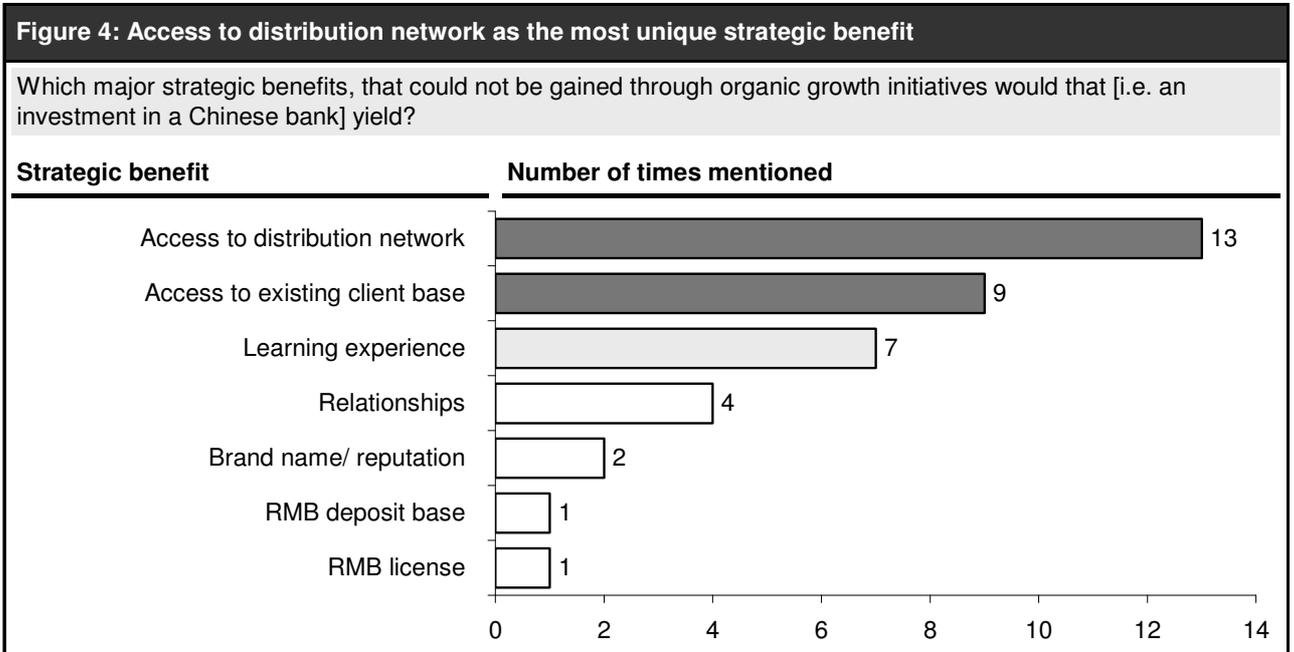
### **2.3.1 Presentation of survey results**

#### *2.3.1.1 Sources of value*

The survey participants were asked to identify the unique strategic benefits of investments in Chinese banks, which could not be gained through organic growth alternatives. Figure 4 (below) sets forth the obtained results. The total number of times any given category was mentioned is not related to the number of respondents, as multiple nominations were permissible.

From the following figure, it can clearly be seen that access to the target's distribution network (13 times mentioned) is most widely considered to be the greatest benefit foreign financial institutions can get from investing in Chinese banks. The point made by most respondents naming this benefit was, that foreign banks lack of geographical reach and distribution power would be their biggest competitive disadvantage in China. Gaining access to an existing and

comprehensive infrastructure by taking an equity stake in a domestic player would be the fastest way of compensating for this disadvantage.



Source: own illustration and calculations

The second most frequently named strategic benefit was the, through an investment achievable access to the target’s existing client base (9 times mentioned). Most respondents explained this in a purely quantitative context by referring to Chinese banks’ huge numbers of corporate and retail clients and the possibility of realizing economies of scale by tapping into these client bases. This would be particularly critical for designing mass market retail products at competitive prices.

Some interviewees also spotted a qualitative dimension here. One foreign bank executive for instance voiced the opinion, that some of China’s most attractive enterprises would have built long-lasting banking relationships with domestic banks and that taking the detour of selling products under a Chinese bank’s brand name would be the only way of accessing these clients at all.

The third most frequently cited benefit of investing in Chinese banks was the herewith associated learning experience (7 times mentioned). Interviewees generally distinguished three

broad areas, in which foreign banks could greatly benefit by learning from local players. These were market usages, client behavior and needs and the internal setup of the bank which is invested in.

Some participants particularly highlighted the value of having a local partner to assist in navigating in the, for many foreign banks alien cultural and market environment. Other interviewees pointed out, that the huge client bases of many Chinese banks would offer ample opportunities to study and analyze the average Chinese client's service requirements and preferences. Further to that, one of the strategy consultants interviewed made the point that an equity investment in a Chinese bank would provide the acquirer with the rare opportunity to adopt an insider's view of the internal setup up of the target and learn about its main strengths and weak points. All of these learning experiences could be used to accelerate the foreign bank's own learning curve in the Chinese market and could also be applied to its organic growth efforts.

Accessing the target's informal network of relationships (*guan xi* in Mandarin) was mentioned four times as a unique strategic benefit. Here, respondents mostly had relationships to political decision makers and regulatory authorities in mind. It was pointed out, that possessing good personal relationships to the respective authorities could considerably speed up various bureaucratic processes.

The remaining points mentioned as unique strategic benefits from investments in Chinese banks were: brand name/ reputation, RMB deposit base and RMB licenses. Since they were only named by one or two respondents each, they shall not be discussed in equal detail as the previous items. Brand name/ reputation referred to the low familiarity of Chinese consumers with foreign bank brands. By generating business through a local bank it is invested in, the foreign bank could according to the respondents capitalize on the local player's established brand name and reputation. RMB deposit base and RMB licenses were not further commented on and only mentioned once each.

2.3.1.2 Target selection

The survey participants were next asked to identify the, according to their view most suitable targets for foreign direct investments. Almost all respondents remained at the level of discussing investments in various groups of banks (which was explicitly asked for) and only two individual players were highlighted as exceptionally attractive targets. Figure 5 (below) provides an overview of the answers obtained as well as the key investment considerations set forth by the participants to explain their respective choices. The total number of times any given category was mentioned is not related to the number of respondents, as multiple nominations were permissible.

**Figure 5: Second and Third tier banks best suited for foreign investors**

Given the structure of the Chinese banking sector, which group of banks or which individual player would you consider best suited for foreign investments and why?

Bank groups	Times mentioned	Key investment considerations
Joint-stock commercial banks	11 	Nationwide license, control might be achievable in the future, modern structures, willing to learn, relatively low NPL ratios, reasonable investment size
City commercial banks	10 	Highest potential, SME expertise and focus, influence achievable, opportunities through future sector consolidation, lower complexity, reasonable investment size
State-owned commercial banks	4 	Huge branch networks, political signal, financial investment, acceptable transparency/ corporate governance/ NPL ratios
Rural credit cooperatives	1 	Small in size, influence achievable, reasonable investment size
Urban credit cooperatives	0	-
Others	0	-
Individual players	Times mentioned	Key investment considerations
China Merchants Bank	2 	Entrepreneurial player, healthy balance sheet, well positioned
China Minsheng Bank	2 	Entrepreneurial player, healthy balance sheet, well positioned

Source: own illustration and calculations

The survey results show a clear preference of respondents towards joint-stock commercial banks (11 times mentioned) and city commercial banks (10 times mentioned). Interviewees arguing for joint-stock commercial banks referred back to gaining access to a nationwide branch network as a major benefit of investing into a Chinese player, which would be achievable through taking an equity stake in a JSCB. While the big four would feature even larger branch networks, respondents explained their preference for second tier banks with their more

modern, less bureaucratic structures and their greater willingness to learn, which would make it easier for foreign investors to effect changes in the targets' corporate governance and credit approval processes. They furthermore pointed to the JSCB's relatively healthy balance sheets (low NPL ratios) and the fact that their smaller size allows a foreign investor to acquire an adequate equity stake at a reasonable price. Investing in the big four would on the contrary require a much higher financial commitment for a comparatively lower equity share and would therefore not be a viable choice for many foreign banks. Some interviewees also noted that they expect equity control to become achievable in some JSCB's in the near future. Making an investment in these banks today would therefore provide an ideal starting point to capitalize on this opportunity, once it arises. Both individual players nominated as prime investment targets, China Merchants Bank and China Minsheng Bank belong to the group of JSCB's.

According to the survey results, city commercial banks are the second best choice for foreign strategic investors. Most respondents voting for CCB's argued again that their relatively small size would allow investors to purchase adequate shares of the targets' equity at reasonable prices and that equity and management control might realistically be achievable in the future. It was furthermore noted, that city commercial banks would be particularly well positioned in SME lending, one of the Chinese banking market's big growth opportunities<sup>29</sup>. Some respondents added that due to their small size and regional scope of operations, investments in city commercial banks would be less complex than in bigger players and therefore easier for foreign investors to handle.

Strategic investments in the big four state-owned commercial banks emerged only as the third best option. The most frequently provided reason for the suitability of SOCB's for foreign investors was the herewith associated opportunity of gaining access to their huge branch networks. At the same time, many respondents noted that foreign investors' influence on SOCB's would be extremely limited. A small number of respondents stated however, that investments in the big SOCB's could be strategically beneficial even if no operational gains were attached to it. Investing would be an important tool of demonstrating long-term com-

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<sup>29</sup> Löchel, Horst (2006), p.138, Industrial and Commercial Bank of China Limited (2007), p. 103.

mitment to the Chinese market and thus make it easier for the foreign bank to gain political support for other business ventures in the country. The risks associated with investments in the big four would be manageable due to their by today acceptable transparency and corporate governance levels as well as their relatively low NPL ratios. Respondents explicitly limited these features to the publicly listed SOCB's (i.e. they excluded the Agricultural Bank of China).

As for other groups of banks or players, only one participant considers rural credit cooperatives due to their small investment size and the probability of gaining management influence to be good investment targets.

## **2.3.2 Discussion of key findings**

### *2.3.2.1 Distribution network as primary attraction*

The majority of respondents named access to the target's existing distribution network and client base as the two most unique strategic benefits gained through investments in Chinese banks. The herewith associated learning experience ranked third in the survey. It was shown earlier in this paper that foreign banks' greatest competitive weakness is their lack of distribution power in China. Section 2.2.2.1. furthermore concluded that this issue can not be adequately tackled by solely relying on organic growth initiatives. Seeking strategic investments in Chinese banks with the rationale of gaining access to their vast and widespread branch networks is therefore an absolutely logical step to complement organic growth. Access to an existing distribution network goes hand in hand with access to the existent client base, which is being served through this network. This provides the foreign strategic investor in turn with the critical mass of clients to launch products such as bank cards cost efficiently in China. In fact, many of the more prominent investments in recent years were officially justified by either referring to the targets' distribution networks or customer bases (see table 1 below).

**Table 1: Precedent transactions mostly target distribution network and customer base**

Year	Target	Investor	Acquired stake	Deal value (USD m)	Transaction rationale
2004	Bank of Communications	HSBC	19.90%	1,750	distribution platform (credit cards)
2005	Bank of Beijing	ING Group	19.90%	215	distribution platform (retail banking)
2005	Bank of China	RBS	5.00%	1,550	brand, distribution platform, customer base
2005	Bank of China	UBS AG	1.60%	500	brand, distribution platform, customer base
2005	China Construction Bank	Bank of America	9.00%	2,500	customer base
2005	ICBC	Allianz Group	2.50%	1,000	distribution platform (insurance/ investment products)
2005	ICBC	American Express	0.50%	200	distribution platform (bank cards)
2006	Huaxia Bank	Deutsche Bank	9.90%	220	distribution platform (credit cards, wealth management, investment products)

*Source: own illustration and calculations based on Bank of America (2007), p. 17 / HSBC (2004). / RBS (2005). / UBS (2005). Deutsche Bank (2006). / Goldman Sachs (2006). / ZEPHYR database analysis*

The benefit of advancing institutional learning about the Chinese market, customer needs and local business culture is usually not highlighted in official statements. This might largely be attributed to the nature of these announcements, in which the investing party is generally eager to present a win-win situation by focusing on the transaction's benefits for the target after having briefly mentioned its own most obvious gains. Secondly, studying client behavior and internal structures at the target are rather sensitive issues which would be inappropriate to communicate too openly. Based on publicly available information, it is however difficult to assess whether the unique learning opportunities created through equity investments in Chinese banks are already fully realized and capitalized on by today.

### 2.3.2.2 *Second and third tier banks as most attractive targets*

The survey results suggest that joint-stock commercial banks would be best suited for foreign strategic investors. City commercial banks emerged as the second best choice and the big four ranked third. This section will take a more detailed look at the respective bank group's strengths and weaknesses to assess their attractiveness to foreign investors.

In 2006, there were 13 joint-stock commercial banks in China. Even though they possess nationwide banking licenses, their activities are generally focused on their headquarters' regions as well as the traditional banking clusters alongside China's coastline (Bohai Rim Zone,

Yangtze River Delta and Pearl River Delta)<sup>30</sup>. Table 2 (below) provides an overview of China's joint-stock commercial banks, their key data and shows which banks have already attracted foreign strategic investors.

With an average of 451 outlets<sup>31</sup>, their branch networks are comprehensive enough for foreign banks to access a sufficiently broad customer base and generate economies of scale. While the JSCB's distribution power in terms of sales force size is considerably weaker than that of the big four, they are at the same time leaner and more flexible from an organizational point of view. As a result hereof, they are able to react more rapidly to changing market conditions than the big four.

**Table 2: Most joint-stock commercial banks are already invested in**

Bank	Total assets in RMB bn <sup>1)</sup>	Market share in % <sup>2)</sup>	Number of Branches	Foreign strategic investor	Total stake
Bank of Communications (BoCom) <sup>3)</sup>	1,423.4	3.8%	2,607	HSBC	19.90%
China Merchants Bank	734.6	2.0%	456	-	-
China CITIC Bank	594.6	1.6%	416	BBVA	4.83%
Shanghai Pudong Development Bank	573.5	1.5%	350	Citigroup	4.60%
China Minsheng Bank	557.4	1.5%	240	Temasek Holdings, IFC	5.60%
China Everbright Bank	530.1	1.4%	382	Asian Development Bank	1.90%
Industrial Bank	474.8	1.3%	328	Hang Seng Bank, GIC Singapore, IFC	24.90%
Huaxia Bank	356.5	1.0%	266	Deutsche Bank, Sal. Oppenheim	14.00%
Guangdong Development Bank	355.8	0.9%	500	Citigroup, IBM	24.74%
Shenzhen Development Bank	222.4	0.6%	238	Newbridge Capital	17.89%
Evergrowing Bank	37.0	0.1%	76	Standard Chartered	15.00%
China Zheshang Bank	21.8	0.1%	6	-	-
China Bohai Bank <sup>3)</sup>	n/a	n/a	1	Standard Chartered	19.99%
<b>Total</b>	<b>5,881.9</b>	<b>15.7%</b>	<b>5,866</b>		
<b>Average (including BoCom)</b>	<b>490.2</b>	<b>1.3%</b>	<b>451</b>		
<b>Average (excluding BoCom)</b>	<b>405.3</b>	<b>1.1%</b>	<b>272</b>		

1) To facilitate comparability, all figures are from 2005 as no 2006 figures were available for many banks  
 2) Reclassified as a large state owned bank in 2007 by CBRC  
 3) China Bohai Bank started operations on 16 February 2006

Source: own illustration and calculations based on CBRC (2007), China CITIC Bank (Ed.) (2007), p. 56 / China Bohai Bank (2007), Anderlini, Jamil / Thal Larsen, Peter / Böschen, Mark (2007).

Even though every player has its own unique characteristics, joint-stock banks share a common set of competitive advantages over other domestic bank groups. Owing to their partially

<sup>30</sup> Garcia-Herrero, Alicia/ Santabarbara, Daniel (2004), p. 14.

<sup>31</sup> Own calculation based on China CITIC Bank (Ed.) (2007), p. 56.

private ownership structure and the fact, that they were never heavily engaged in policy lending<sup>32</sup>, they have a more market oriented and entrepreneurial corporate culture than the big four or the city commercial banks<sup>33</sup>.

Being already more commercially oriented than other bank groups in China, JSCB's might be more adaptive to international best practices brought in by foreign investors. Since the joint-stock banks have no significant history of policy lending, they were generally able to avoid piling up the for Chinese credit institutions characteristic high amounts of non-performing loans<sup>34</sup>. This allows them and their foreign investors to focus on future growth rather than on cleaning up balance sheets.

Foreign banks could also greatly benefit from the JSCB's localized expertise and cooperate in creating new products which are custom tailored to the Chinese market. It therefore can be concluded that joint-stock banks are indeed very well suited for foreign investments, which is confirmed by the fact, that almost all of them are already invested in.

The survey results ranked city commercial banks as the second most attractive group of investment targets. In 2006, there were 113 city commercial banks (CCB's) in China. While every individual CCB's market share is negligible on a nationwide basis, they are well established in their home cities, where they generally rank amongst the top 3 to 5 players. Their distribution networks comprise 50 branches on average, but the largest ones operate over 200 outlets<sup>35</sup>. Even though regionally concentrated in their headquarters' municipalities, they still outnumber the nationwide branch networks of leading foreign banks in China by far. Investing into a CCB would therefore allow a foreign bank to gain a degree of regionally focused market penetration, which would be completely unachievable through organic growth.

The CCB's key attraction and competitive advantage lies in their deep local roots in their municipality. They possess preferred access to local knowledge and information and have estab-

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<sup>32</sup> The Economist Intelligence Unit (Ed.) (2007), p. 22.

<sup>33</sup> CBC Shanghai (Ed.) (2006), p. 17 and Deutsche Bank Research (Ed.) (2004), p. 4.

<sup>34</sup> Abotsi, Kodjo (2007), p. 3.

<sup>35</sup> KPMG (Ed.) (2005), p. 7.

lished extremely strong relationships to key decision makers at local governments<sup>36</sup>. Being well connected in the local business and political scene, they have a clear advantage in the relationship driven commercial banking business with small and medium sized enterprises in their municipalities<sup>37</sup>.

The CBRC also announced in April 2007 that it would enable well performing city commercial banks to expand beyond the borders of their headquarters' municipalities<sup>38</sup>. By way of exception, the Bank of Beijing and Bank of Shanghai were already allowed in 2006 to open branches in Tianjin and Ningbo respectively<sup>39</sup>. The newly created possibility of cross-regional expansion has definitely increased the attractiveness of CCB's to foreign investors further.

On the flipside, CCB's face severe problems, investors should be aware of. These include their narrow, undifferentiated product offering paired with low innovative potential, inefficient internal management and risk controls and a lack of qualified staff<sup>40</sup>. Additionally, many CCB's are currently preoccupied with cleaning up their balance sheets and therefore lack the necessary resources to proactively launch growth initiatives. While the official total NPL ratio of city commercial banks was with 4.78% lower than that of SOCB's (9.22%) in 2006<sup>41</sup>, some individual banks are estimated to be burdened much heavier. In 2004, unofficial sources suspected non-performing loans to account for over 50% of some CCB's loan books<sup>42</sup>.

The high geographical concentration of CCB's loan portfolios increases their balance sheets' structural weakness further<sup>43</sup>, as it makes them overly vulnerable to a local economic slowdown in their respective cities. According to *The Banker*, only approximately 30 city commercial banks had decent balance sheets in 2005 and would therefore be suitable investment targets<sup>44</sup>. Summarizing the above, city commercial banks indeed possess some unique characteristics making them well suited for foreign banks pursuing a regionally focused market de-

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<sup>36</sup> Deutsche Bank Research (Ed.) (2006), p. 6.

<sup>37</sup> KPMG (Ed.) (2005), p. 5.

<sup>38</sup> CBRC (2007b).

<sup>39</sup> CBRC (2007), p. 42.

<sup>40</sup> People's Daily Online (2005).

<sup>41</sup> CBRC (2007c).

<sup>42</sup> KPMG (Ed.) (2005), p. 10.

<sup>43</sup> Deutsche Bank Research (Ed.) (2006), p. 6.

<sup>44</sup> *The Banker* (2005), p. 22.

velopment strategy in China. Due to structural issues faced by most CCB's these investments seem however more risky than those in joint-stock banks. Table 3 (below) provides an overview of city commercial banks which have already attracted foreign investors in recent years.

**Table 3: Many major city commercial banks already invested in**

Year	City commercial bank	Foreign strategic investors	Total foreign equity share
1999	Bank of Shanghai	HSBC, IFC, Shanghai Comm. Bank Hong Kong	18.00%
2001	Nanjing City Commercial Bank	BNP Paribas, IFC	24.9%
2002	Xian City Commercial Bank	IFC, Scotiabank Canada	5.00%
2003	Dalian City Commercial Bank	SHK Hong Kong, Scotiabank Canada, IFC	15.00%
2004	Jinan City Commercial Bank	CBA	11.00%
2005	Bank of Beijing	ING Group, IFC	24.90%
2005	Hangzhou City Commercial Bank	CBA, ADB	24.89%
2005	Nanchong City Commercial Bank	DEG, SIDT	13.00%
2005	Tianjin City Commercial Bank	ANZ Bank	19.90%
2006	Ningbo City Commercial Bank	OCBC Singapore	12.20%
2007	Chongqing Commercial Bank	Dah Sing Bank	17.00%

Source: own illustration and calculations based on KPMG (Ed) (2007), p. 17 / The Boston Consulting Group (Ed.) (2006), p.11 / Löchel, Horst (2006), p. 27f / ZEPHYR database analysis

As shown in section 2.3.1.1. the majority of interview participants considers access to the target's distribution network to be the most unique strategic benefit derived from an investment. The subsequent analysis in section 2.3.2.1 supported this finding. With a combined network of 71,993 branches all over China, the big four state-owned commercial banks should therefore have theoretically emerged as the undisputed first choice investment targets.

A closer look at their market power seems to underpin this assumption. ICBC commands a massive market share of 17.2%, disposes of 18,764 branches<sup>45</sup>, covers approximately 80% of the PRC's small and medium sized enterprises and is estimated to be the country's biggest mortgage lender<sup>46</sup>. With 28,234 branches, the Agricultural Bank of China disposes of the largest distribution network of all Chinese banks and hence a unique reach into the country's remote rural areas. It had a market share of 12.7% in 2005. The Bank of China claims dominant

<sup>45</sup> China CITIC Bank (Ed.) (2007), p. 55.

<sup>46</sup> The Economist Intelligence Unit (Ed.) (2007), p. 15f.

positions in foreign exchange, international settlement and trade finance. It commands a market share of 12.7% and disposes of 11,018 branches<sup>47</sup>. China Construction bank claims market leadership in infrastructure loans, residential mortgage and bank cards<sup>48</sup>. Its market share amounts to 12.2% and its distribution network consists of 13,977 branches<sup>49</sup>. Table 4 (below) illustrates the big four's dominant market position and lists their major foreign strategic investors.

**Table 4: Big four state-owned commercial banks - unparalleled distribution power**

<b>Bank</b>	<b>Total assets in RMB m<sup>1)</sup></b>	<b>Market share in %</b>	<b>Number of Branches</b>	<b>Major foreign strategic investors<sup>2)</sup></b>
ICBC	6,456,131	17.2%	18,764	Goldman Sachs, Allianz Group, American Express
ACB	4,771,019	12.7%	28,234	not invested in
BOC	4,742,806	12.7%	11,018	RBS, Merrill Lynch, UBS
CCB	4,585,742	12.2%	13,977	Bank of America
<b>Total</b>	<b>20,555,698</b>	<b>54.9%</b>	<b>71,993</b>	

1) To facilitate comparability, all figures are from 2005 as no 2006 figures were available for ACB.

2) Includes only strategic investors engaging in meaningful strategic cooperation.

*Source: own illustration and calculations based on China CITIC Bank (Ed.) (2007), p. 55 / Goldman Sachs (2006). / KPMG (Ed) (2007), p. 17*

These figures allow for two conclusions. They firstly confirm the general suitability of investments in the big four to gain access to a comprehensive distribution network and huge client base. But they secondly also indicate how difficult it is for a foreign investor to effect even minor changes in these gigantic institutions. It has also been shown in chapter 2.2.2.2., how concerned the Chinese government is with maintaining control over the country's leading financial institutions. Against this background, there is no chance for a foreign investor to gain meaningful management control over one of the big four, which greatly reduces their attractiveness. Acquiring even small equity stakes in the big four is due to their vast size much more expensive than in second or third tier banks and therefore for many smaller and medium sized foreign banks per se no viable option.

<sup>47</sup> China CITIC Bank (Ed.) (2007), p. 55.

<sup>48</sup> China Construction Bank (2007).

<sup>49</sup> China CITIC Bank (Ed.) (2007), p. 55.

While the above analyzed the respective strengths and weaknesses of the, according to the survey results most popular target groups, it goes without saying that every investment decision is unique and proper target identification can therefore only be conducted on a case by case basis. Factors such as the foreign bank's own value proposition, its market development strategy in China, the strategic fit between acquirer and target and the willingness of the target's management to cooperate are all of paramount importance and vary greatly from transaction to transaction. The above conducted analysis rather demonstrated that every bank group has its own characteristic strengths and weaknesses, which should be taken into consideration. Apart from that, it excluded one crucial point: the availability of attractive targets.

It has been shown throughout this section, that most of the joint-stock and state-owned commercial banks as well as many of the bigger city commercial banks are already invested in. This leads to the question, whether they have for this reason become completely unapproachable for other foreign investors. A review of the available research literature suggests that the maximum combined equity proportion held by all foreign investors in one Chinese bank may not exceed 25%<sup>50</sup>. The conclusion drawn from this is that attractive targets are becoming exceedingly rare in China.

There seems to be however a loophole in the 25% cap on the combined foreign ownership in Chinese banks. Article 9 of the relevant "Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions" (Rules) enacted in December 2003 reads as follows:

*Where the combined equity investment proportion of all overseas financial institutions in a non-listed Chinese financial institution is equal to or exceeds 25 percent, the non-listed Chinese financial institution shall be treated as a foreign-funded financial institution by the regulatory authority.*

*Where the combined equity investment proportion of all overseas financial institutions in a listed Chinese financial institution is equal to or exceeds 25 percent, the listed Chinese finan-*

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<sup>50</sup> The Boston Consulting Group (Ed.) (2006), p.15 /  
The Economist Intelligence Unit (Ed.) (2007), p. 25 / CBC Shanghai (Ed.) (2006), p.24 /  
Anderlini, Jamil / Thal Larsen, Peter / Bösch, Mark (2007), Löchel, Horst (2006), p. 37 /  
Zhao, Xiaojun (2006), p. 6 / Taylor, Peter (2006), p.107 / Pelzl, Ursula (2006), p. 41.

*cial institution shall still be treated as a Chinese financial institution by the regulatory authority*<sup>51</sup>.

This case discrimination explicitly regulates the eventuality of combined foreign ownership exceeding 25% of a target's equity. The only undesirable consequence of that, a reclassification of a non-listed Chinese bank into a foreign-funded financial institution can easily be circumvented by local incorporation. According to the in December 2006 enacted "Regulations of the People's Republic of China on Administration of Foreign-funded Banks" (Regulations), locally incorporated foreign-funded financial institutions enjoy the same regulatory treatment as Chinese financial institutions. This would suggest that the publicly perceived 25% cap on combined foreign ownership of Chinese banks would be legally non-existent. It was unfortunately not possible to achieve final clarification of this issue within the scope of this paper and its accompanying research. The fact, that the 25% threshold has not been contested yet, suggests however that this loophole is more theoretical in nature. Transactions trying to outmaneuver the legal framework would most probably fail to obtain regulatory approval from the CBRC who retains the right of interpretation of the Rules (Article 20 of the Rules).

## **2.4 Realizing value in an investment – challenges to deal with**

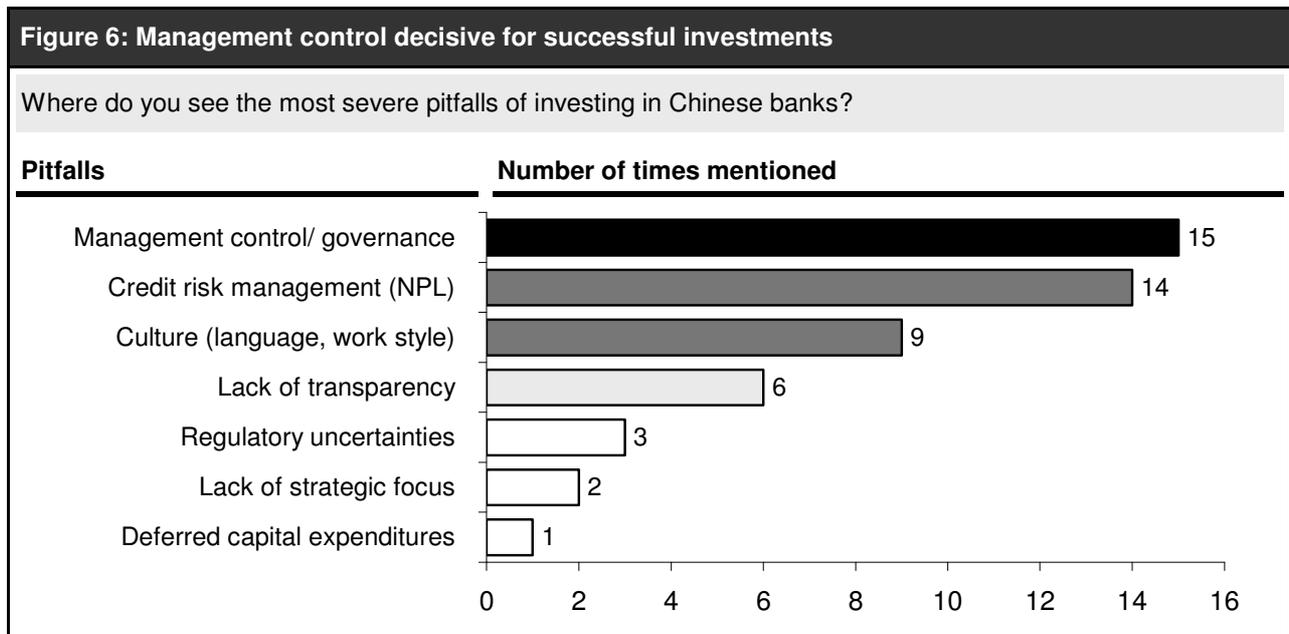
The so far discussed questions examined whether it would generally make sense to acquire minority stakes in Chinese banks, which unique strategic benefits this would yield and which targets would be best suited to invest in. In order to make a well informed final decision on whether equity investments in Chinese banks should constitute an integral part of a foreign financial institutions' China strategy, it is important to gain an awareness of the problems and pitfalls these investments hold. The empirical survey conducted therefore addressed these issues.

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<sup>51</sup> CBRC (2003).

### 2.4.1 Presentation of survey results

Figure 6 (below) provides an overview of the answers obtained. The total number of times any given category was mentioned is not related to the number of respondents, as multiple nominations were permissible.



Source: own illustration and calculations

The majority of all respondents clearly perceive the lack of control over the investment target in conjunction with the frequently low corporate governance standards at Chinese banks as the most pressing issue. They stated that since foreign investors were confined to playing the role of minority shareholders, it would be extremely hard for them to assume meaningful management control. At the same time they argued, that a certain degree of management control would be crucial to the integration of a strategic investment into a foreign bank’s overall China strategy. A great number of respondents directly linked the issue of gaining management control to the often poor quality of corporate governance at Chinese banks. Two strategy consultants and one foreign bank executive raised the point, that even if a foreign investor would be able to formally secure management control, this would not automatically guarantee its enforceability. The explanation given for this was that the official power structure would not necessarily equal the true chain of command at Chinese banks. Due to the decentralized structures of larger credit institutions, it would still occur that individual branches operate

relatively autonomously from headquarter decisions and would be subject to massive influence from local governments in their region.

The underdeveloped credit risk management and resulting high levels of non-performing loans at many Chinese banks emerged as the second most severe pitfall foreign investors would have to deal with. Many respondents stated that especially listed banks already made great progress in these regards in recent years but that it would nonetheless be of paramount importance for foreign investors to conduct extensive due diligence on the loan book quality and risk management function in order to avoid unpleasant surprises later on.

Cultural disparities between foreign and Chinese banks were the third most frequently mentioned pitfall. This included the generally existing language barrier between the Chinese and foreign side. Some interviewees also pointed to culturally founded differences in management and work style, which would make it difficult for foreign investors to implement changes at the investment target and to realize their strategic goals. Another frequently quoted problem to deal with is the lack of transparency encountered at many Chinese banks. This would make the assessment of the risks taken in an investment a very delicate issue.

Apart from these major concerns, some respondents also mentioned regulatory uncertainties, a lack of strategic focus on the investor's side and deferred capital expenditures (e.g. costly replacement of malfunctioning IT-infrastructure) as pitfalls to be aware of. Especially the strategy consultants interviewed were very specific about the point, that foreign financial institutions investing in Chinese banks must be absolutely clear about the goals they want to achieve this way in order to truly generate value.

#### **2.4.2 Discussion of key findings**

Difficulties in gaining and enforcing management control were the most frequently quoted challenges foreign banks must deal with in their strategic investments in China. This result is perfectly in line with two surveys published by PricewaterhouseCoopers in September 2005 and May 2007, in which senior executives from foreign banks (35 and 40 respectively) repeatedly ranked the "ability to exercise management control" as their greatest concern in

teaming up with a Chinese partner<sup>52</sup>. While it is true, that the degree of management control, foreign banks can expect to achieve through acquiring a minority stake of less than or equal to 20% is in most cases extremely limited, there are examples of foreign investors effectively controlling Chinese banks. These are the already described cases of Shenzhen Development Bank (Newbridge Capital, minority stake: 17.9%) and Guangdong Development Bank (Citigroup, minority stake: 20.0%). Newbridge Capital achieved management control by securing the right to appoint the chairman and other senior executives at the target<sup>53</sup>. Citigroup installed one of its longtime bankers as president of Guangdong Development Bank and holds 6 out of 17 board seats<sup>54</sup>. Admittedly, these cases are rare exceptions, but they could serve as role models for similar arrangements at smaller joint-stock or city commercial banks in the future.

However, there are a few factors indicating, that official management control does not always guarantee the ability to truly exercise it. The first reason for this is the Chinese state's persistent influence over domestic banks. The big four state-owned commercial banks are under the 1995 enacted Commercial Banking Law still required to adhere to orders from the State Council regarding lending decisions<sup>55</sup>. The State Council also determines the repayment method of loans extended to special projects<sup>56</sup>. Further to that, the ruling communist party commands a well-functioning network allowing it to circumvent the board of directors and shareholders' meeting in effecting decisions at domestic banks<sup>57</sup>. In 2005, Guo Shuping, chairman of China Construction Bank together with Xie Ping, head of Central Huijin Investment<sup>58</sup> publicly complained about CCB's party committee excessive influence over the bank's operations and management which would be "contrary to CCB's corporate bylaws"<sup>59</sup>.

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<sup>52</sup> PricewaterhouseCoopers (Ed.) (2005), p. 36 / PricewaterhouseCoopers (Ed.) (2007), p. 46.

<sup>53</sup> International Herald Tribune (Ed.) (2006).

<sup>54</sup> The bank officially denies to have full management control, but states that it "...does exert influence through its board representation.". Source: Carew, Rick (2007).

<sup>55</sup> The Standing Committee of the National People's Congress (1995), article 41.

<sup>56</sup> Lee, Dongwook (2005), p. 38.

<sup>57</sup> Taylor, Peter (2006), p. 107.

<sup>58</sup> Central Huijin Investment is the government controlled investment vehicle through which the Chinese state holds its shares in the big four state-owned commercial banks.

<sup>59</sup> McGregor, Richard (2005).

In this regard, it is also worth noting that senior executives at banks are generally appointed by the state or communist party in China, which was also criticized by Xie Ping. This practice also applies to banks with partial private ownership (including the officially private China Minsheng Bank) and those listed at stock exchanges<sup>60</sup>. The consequence of this is that it is extremely difficult, if not impossible for foreign investors to replace uncooperative or incompetent (middle) management without consent from the respective decision makers at various government or party levels.

Beyond that, most banks' decentralized structures make their vast branch networks difficult to control and leave remote branches vulnerable to politically influenced lending<sup>61</sup>. Many Chinese banks still operate outdated and non-uniform IT-platforms. Key processes are therefore frequently paper based, which makes them hard to trace and control from head offices<sup>62</sup>. Even joint-stock banks, which generally possess higher corporate governance standards than other groups of Chinese banks, experienced difficulties in controlling their branches in the recent past. A characteristic example is the case of Huaxia, in which Deutsche Bank is invested in. The bank discovered in 2003 that its Guangzhou branch bypassed internal risk controls by breaking up bigger loans into several smaller ones<sup>63</sup>. Against this background, upgrading the existing IT-infrastructure and implementing sound control mechanisms appears to be an important task for foreign investors in order to fully benefit from the access they gained to the target's distribution network. A certain degree of management control together with the Chinese partner's active support is in any case a necessary prerequisite for this.

Dealing with the for Chinese banks almost notorious issue of weak credit risk management and high levels of non-performing loans is according to the survey results the second most decisive challenge for foreign investors. Many Chinese banks are well aware of their problems and have already made noteworthy progresses in reducing their non-performing loan ratios. This can however to a large extent be attributed to the rapid expansion of their loan books and in the case of the big four to the government initiated removals of NPL's from the

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<sup>60</sup> Taylor, Peter (2006), p. 96 / Lee, Dongwook (2005), p. 35.

<sup>61</sup> He, Liping/ Fan, Xiaohang (2004), p. 12.

<sup>62</sup> CBC Shanghai (Ed.) (2006), p. 20.

<sup>63</sup> The Banker (2005b).

banks' balance sheets<sup>64</sup>. According to some reports, lending and risk management practices have not been improved significantly in recent years<sup>65</sup>. A working paper published by the International Monetary Fund (IMF) in March 2006, for instance analyzed the lending behavior of the big four state-owned commercial banks during the time from 1997 to 2003. It found, that they essentially did not take their borrowers' credit worthiness into account and that lending was primarily driven by the availability of funds<sup>66</sup>. In another working paper published in December 2006, the IMF concluded that the structures of foreign investors' strategic agreements might not provide them with sufficient opportunities to improve the risk management of their Chinese partners<sup>67</sup>. This research indicates that the problem of non-performing loans might not be solved in the short-term and that gaining control of and enhancing the target's risk management function is critical to securing its long-term value.

Culturally founded differences in management and work style between the Chinese and foreign side can make this task extremely difficult. The case of Bank of China's first foreign chief credit risk supervisor Lonnie Dounn, who resigned in 2006 after only 16 months as a result of personal difficulties in dealing with cultural and communication related issues exemplifies this<sup>68</sup>. To deal with the potential cultural clash, foreign banks are confronted with the difficult task of recruiting staff with an excellent international skill set and track record on the one hand and a deep understanding and appreciation of the Chinese business mentality on the other hand to mediate between their headquarters and the investment target's management.

### 3 Final conclusions

It was demonstrated throughout this paper, that there are indeed several unique strategic benefits to be derived from investments in Chinese banks. Most importantly, these transactions represent the fastest, most economic and effective way of gaining access to a meaningful dis-

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<sup>64</sup> McKinsey Global Institute (Ed.) (2006), p. 14.

<sup>65</sup> McKinsey Global Institute (Ed.) (2006), p. 14 / DZ BANK AG (Ed.) (2004), p. 24f.

<sup>66</sup> Podpiera, Richard (2006), p.18.

<sup>67</sup> Leigh, Lamin / Podpiera, Richard (2006), p. 7.

<sup>68</sup> People's Daily Online (2006). / International Herald Tribune (Ed.) (2006b).

tribution network. They furthermore enable foreign banks to tap their Chinese counterparts' frequently huge client bases. This in turn allows foreign banks to leverage the local knowledge and market position of their Chinese partners in order to educate themselves further about the peculiarities of the Chinese market and customer requirements. These strategic benefits are unique to investments in Chinese banks and could not be realized through organic growth. It is very straightforward, that large scale access to a Chinese player's client base and local knowledge requires the close cooperation established through an equity investment. Due to regulatory restrictions, foreign banks are furthermore unable to match Chinese banks' vast distribution networks by building up the necessary infrastructure from scratch.

It could be shown in this paper, that joint-stock commercial banks are adequate investment targets for foreign banks pursuing a nationwide strategy, while city commercial banks would allow for a highly focused regional market exploration. The final target selection is however strongly influenced by the involved players' individual strategic profiles as well as the availability of attractive targets. The most critical point in selecting a target is according to the research results the ability to exercise a certain degree of management control and to avoid banks burdened with excessive non-performing loan ratios. While there are still several promising City Commercial Banks available to foreign investors, the practically applied cap on foreign ownership of Chinese financial institutions makes it hard to find adequate targets.

The question, whether equity investments in Chinese banks would be indispensable for foreign banks to succeed in the Chinese banking market could not be finally answered. While it was pointed out, that most of the leading foreign banks in China are invested in domestic players, there is one prominent exception to this. Being highly successful, the Bank of East Asia so far solely relies on organic growth in China. Notwithstanding this, investments in Chinese banks nowadays constitute an integral part of most leading players' market exploration strategy.

## Appendix

### Appendix 1: Research questionnaire

1. As of today, foreign banks may only acquire 20% of a Chinese bank's equity. Do you expect this regulation to change over the next 1-2 years?
2. Would you advise a foreign bank to acquire a minority stake in a local bank as a strategic means of exploring the Chinese market?
3. Which major strategic benefits, that could not be gained through organic growth initiatives would that [i.e. an investment in a Chinese bank] yield?
4. Given the structure of the Chinese banking sector, which group of banks or which individual player would you consider best suited for foreign investments and why?
5. Where do you see the most severe pitfalls of investing in Chinese banks?
6. Given the sector's current and expected future development, would you describe investments in Chinese banks as financially attractive at this stage?

## Appendix 2: List of survey participants

#	Firm	Location	Date	*)
1	Commerzbank AG	Hong Kong	18.05.07	p
2	Commerzbank AG	Hong Kong	25.05.07	p
3	Commerzbank AG	Shanghai	29.05.07	p
4	Commerzbank AG	Hong Kong	25.05.07	p
5	Deloitte & Touche Corporate Finance Ltd.	Hong Kong	18.05.07	t
6	Dresdner Bank AG	Shanghai	04.06.07	p
7	DZ BANK AG	Shanghai	31.05.07	p
8	Goldman Sachs	Hong Kong	04.07.07	t
9	LBBW	Shanghai	29.05.07	p
10	Nord LB	Shanghai	06.06.07	m
11	Oliver Wyman	Shanghai	30.05.07	t
12	Quam Capital Limited	Hong Kong	17.05.07	p
13	Quam Capital Limited	Hong Kong	23.05.07	p
14	Roland Berger Strategy Consultants	Shanghai	31.05.07	p
15	Savings Banks Foundation for International Cooperation	Shanghai	01.06.07	m
16	Standard Chartered	Shanghai	05.06.07	p
17	The Bank of East Asia	Hong Kong	16.05.07	p
18	The Boston Consulting Group	Beijing	30.05.07	t
19	UBS AG	Hong Kong	12.06.07	p
20	WestLB AG	Shanghai	05.06.07	t
21	ZDH Partnership Program (China)	Shanghai	29.05.07	p

\*)

p personal interview

t telephone interview

m questionnaire answered via e-mail

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