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China's Banking Industry**

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THE IMPACT OF DIRECT INVESTMENT BY FOREIGN BANKS ON CHINA'S BANKING INDUSTRY

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Abstract

This paper analyzes the impact of foreign participation on Chinese banking by studying its different manifestations in China's commercial banks. We find that strategic investors play an important role when state-owned commercial banks (SCBs) and other shareholding banks start their IPO processes, either abroad or in the local market. Foreign strategic investment, in most cases, promises to benefit China's commercial banks by transferring management knowledge. Data show that most banks entering partnerships with foreign interests derive "direct benefits:" they improve their capability for financial innovation – in structural reorganization, and new products and services -- by this transfer of management knowledge from their foreign partners. In addition, "demonstration benefits" from this transfer process could spread to other banks that endeavor to emulate the improved management practices and superior strategy shown by foreign-invested banks within an environment of heightened competition.

The acquisition of a foreign partner leads, initially, to culture shock; synergies come later. Adherence to traditional practices by and inflexibility of local managers and employees are important, lingering factors that impede the transfer of management knowledge after foreign investors acquire shares in local banks. As a likely consequence, a key finding of the empirical assessment herein is that Chinese banks with foreign investment appear to be no more efficient than those without. Moreover, when considering the performance of individual banks over time, none shows an obvious improvement in efficiency after accepting foreign investment compared to those that have not. Another important finding is that management cooperation between the foreign investor and managers in the local partner bank is an essential factor for successful investment. Results of the study suggest that there are alternative ways to improve bank corporate governance and risk management, as long as the bank adopts sound practices drawn from international financial experience. As well, to maximize the benefits from foreign strategic investment the Government would do well to ease the restrictions on the ownership share of strategic investors in small- and medium-size commercial banks.

Keywords: foreign bank; strategic investment; China's banking industry; DEA;

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1. Introduction

China's banks still play the dominant role in the Chinese financial system; essentially, China still intermediates financial savings mainly through the banks. Reform of China's financial sector has lagged behind that of the economic system as a whole, and indifferent performance of the financial system remains an impediment to fast, sustainable economic growth. Great effort by the China Banking Regulatory Commission (CBRC) in the past three years has contributed to reducing the banking system's nonperforming loans (NPLs) from RMB 1.70 trillion yuan at end-2005 to RMB 1.25 trillion yuan at end-2007; the ratio of NPLs to total deposits fell from 13.4% to 6.2%¹ in the same period. However, the banking sector remains inefficient and underdeveloped. Moreover, the inability of China's banking system to allocate financial sources efficiently threatens to become an even bigger weakness since it is now (and since December 2006) fully open to competition from foreign banks as guaranteed for accession to the World Trade Organization (WTO).

Underlying the urgency of Chinese financial system reform is concern about capital misallocation. A large volume of lending to underperforming ventures yields negligible returns. The cost to China's economy is high; reform that enabled a larger share of (preferably, all) lending to go to more productive enterprises would increase investment efficiency (McKinsey, 2006). After almost three decades of reform, "the emphasis of policy reform must shift from mobilizing unemployed resources and correcting gross inefficiencies to maximizing efficiency in the allocation of China's scarce capital resources, and nothing is more critical to the efficient allocation of capital than an effective financial system." (Rediel, 2006)

Thanks, at least in part, to its current account surpluses, capital controls, and the accumulation of large foreign exchange reserves, China has avoided financial crises during and after the regional turbulence that erupted towards the end of last century. However, China's banking sector remains in poor shape, with evident weaknesses of associated institutions and governance that could make it vulnerable to potential crisis. That probability would be greater if the capital account is liberalized prematurely. But, given the desirability of capital account convertibility, reforms that equip the financial system, especially banks, to cope with free movements of capital internationally are increasingly urgent. Although banking sector reform might or might not be the "last steps across the river" (Yinping Huang, 2001), it does warrant exceptional attention and care.

¹ China Banking Regulatory Commission CBRC 2007 Statistics.

In setting goals for further reform of the banking industry, priority must be assigned to matching the capacity of the financial system, as a whole, with the requirements for reforming the entire economic system and sustaining economic development. An essential prerequisite is the clarification of equity ownership, and the associated property rights, in banks in order: (i) to enhance competition and foster efficient allocation of capital; (ii) to transform banks from the traditional agents of the credit plan into modern enterprises with adequate capital, which provide highly professional financial services to clients; and (iii) to build sound internal control systems (for risk-management) that underpin the performance of the banking system.

The question is: how can China achieve these goals? Experience has established that successful reform in China can be implemented gradually, and this still appeals as the best way to tackle problems as severe as those that have accumulated in China's banking sector. Unfortunately, at this time, the international environment might not allow China to proceed at the comparatively leisurely pace with which reform was initiated in 1978. China now faces considerable pressure from the outside world, part of which stems from the implementation of China's WTO commitments through 2006, and with foreign banks free to compete in the Chinese market on equal terms banking reform has acquired greater urgency. Whatever the strategy, China will benefit most from a process that smoothly transforms its banking system to a modern one, which also will contribute to global economic development and international financial stability.

Bank failures typically involve both economic and political considerations. It is a given that banks are prone to financial fragility, along with which they play a crucial role in the payments system and the financial markets. With that in mind, in deciding whether or not a large, troubled financial institution should be allowed to fail, officials have to weigh the potentially large impact that such a failure could impose on the financial markets and the real economy. Given the concentration of the Chinese banking sector, the stability of the large Chinese banks might be even more important than that of banks in many other countries. Chinese officials now seem persuaded that foreign direct investment in China's banking industry, including strategic investment in the major banks, is one of the better ways both to foster a healthy, competitive financial system and to protect domestic banks from failure during their transition to better overall performance.

A more competitive environment was a central objective of Chinese reform from its beginnings in 1978, and from the outset China has encouraged foreign banks to establish branches or subsidiaries in China, albeit initially with very limited access to the local market. There has been very substantial

progress from 1978 to 2007, when investment by foreign banks is helping to promote corporate governance reform in the large SCBs and, by forming joint-stock companies, to enable them to issue stock internationally. Several small- to medium-sized banks also are inviting strategic investors from overseas to introduce advanced management practices and thereby to improve their core competitiveness. Attracting foreign banking partners is a first step in a potential banking revolution for the big SCBs and some smaller shareholding commercial banks and city commercial banks in China. The analysis of this development is a principal focus of the research presented in this paper.

There can be no doubt that the extensive opening of financial services to foreign investors and foreign competition as a consequence of China's accession to the WTO entry is a turning point for the Chinese banking sector. However, it does present the Government with something of a policy dilemma. Whatever increases the efficiency of the Chinese financial sector will contribute positively to growth and economic development. But potential exists for foreign banks to out-compete their domestic counterparts with a possible consequence that foreign banks might acquire a predominant share of the Chinese market

Since the end of 2001, as China has removed restrictions on foreign financial institutions, foreign bank branches, representative offices, and their balance sheets, as well as foreign ownership shares in domestic institutions, have grown rapidly. Foreign banks and other financial institutions are becoming important actors in China's financial system. Certainly, growing foreign bank participation, including strategic partnerships, is viewed by many as an integral part of the strategy for reforming China's banking industry.

Within China, however, there is a prevailing debate about the role that foreign banks should play in the domestic financial system. Chief among the unanswered questions are: Will foreign bank entry help to resolve the problems of China's banking sector? Can advanced management practices be acquired through foreign banks' direct investment in China? Some observers are concerned that foreign investors will be reluctant to transfer their expertise to local partners, and few skills will be acquired by Chinese banks. At the same time, China's banks will have ceded a considerable share of their own market to foreign competitors, meaning that the trade off between China's access to banking skills and foreigners' access to Chinese customers will overwhelmingly favor the foreigners. How can authorities ensure that benefits from the entry of foreign banks are both substantial and appropriately distributed? What compromises will ensure a win-win situation?

The research presented here aims at resolving some of these issues. Needless to say, the foreign banks seeking to participate in China are major contributors to the global banking industry as well as to

the international markets for various financial services, more generally. In this study, the focus is limited to FDI in the banking sector. The research analyzes how and to what extent foreign banks' entry to China conveys benefit not only to foreign multinational corporations in China but also to the quality of domestic banking, as well as to domestic small- and medium-sized firms -- to date an issue that has been somewhat neglected in the literature. Of course, there have been some studies on the status of foreign bank penetration in China (Banin and Huang, 2001; Hope and Hu, 2006) and the responses of Chinese banks (He and Fan, 2004), but few studies analyze the performance of Chinese banks with or without foreign strategic investment.

The paper proceeds as follows. The second section reviews previous studies of foreign bank entry to emerging markets. The third section describes foreign banks' direct investment in China since the open door policy was introduced in 1978, and also how the image of China's banking sector has evolved from "ticking time bomb" to "hot property." The fourth section introduces the sample and data used in the research, and provides, by grouping analysis, a comparative study of banks with or without foreign strategic investment. The fifth section presents an empirical assessment of the impact of foreign investment in China's banks based on Data Envelopment Analysis (DEA) methodology. Section six concludes with a summary of the research results and their policy implications.

2. Literature review

There is an extensive literature, including empirical analyses, examining the incentives for and impact of foreign bank entry to emerging economies, which is one of the most important aspects of the internationalization of banking services within a financially globalizing world. In some emerging and transition countries, most banks are large, subsidized, bureaucratic institutions that possess few financial skills and provide such low-quality services that they drive potential customers to transact in parallel markets. Many of these banks are burdened with a legacy of nonperforming loans from state-owned enterprises (as in China's case) or large domestic corporate conglomerates that have been deemed "too big to fail" (Japan, Korea).

Some theoretical studies point to the potential contributions that foreign banks can make in these adverse circumstances; for example, foreign banks can bring diverse financial expertise to emerging-market economies, which holds out the prospects of both lower costs and fewer credit losses. A well-functioning financial system can be a primary driver of economic growth, but in all financial systems there reside the potential for financial fraud and the risk of serious costs to society associated with financial

failures. Consequently, every country imposes regulations intended to ensure that banks are sound, that they allocate financial resources efficiently and thereby foster economic growth, and that they -- along with other financial firms -- deal with the public transparently, fairly and honestly. The design of a regulatory system to achieve these objectives usually requires making often-difficult choices affecting financial efficiency and creativity, institutional and systemic stability, and the ability to ensure compliance with sound business conduct (Roy, 2003).

In their examination of the incentives for and determinants of foreign bank entry to emerging economies, Alicia Garcia Herrero and Daniel Navia Simon (2003) advance explanations for the “third wave” of this entry in the second half of the 1990s. They argue from a microeconomic/behavioral framework that includes factors determining competitive advantages and efficiencies, geographical risk diversification, and some macroeconomic determinants that may push or pull foreign banks going to emerging economies for their international business. The push factors include the home country’s economic cycle, interest rates, and financial condition; pull factors include the host country’s expected economic growth, development of its financial system, and extent of economic integration. They assert that the variables exerting most influence are institutional factors, the host country’s income per capita, and the level and volatility of the economic growth.

There is a broad consensus that size also matters when banks decide to expand abroad, complemented by motives that relate to risk sharing and “following the client.” Torsten Wezel (2004) analyzes the factors crucially affecting the locational decisions of multinational German banks in selected emerging markets of Central and Eastern Europe, Latin America and Asia. He conducts econometric tests on variables representing macroeconomic and financial sector risk along with measures of bank-client integration, host-country market characteristics, and a representative “early warning indicator.” He concludes that, in addition to traditional macroeconomic variables, measures of the risk associated with a country’s financial sector should also be weighed when assessing the determinants of foreign bank entry.

Both theoretical and empirical studies of the impacts of foreign bank entry to emerging economies show that such entry improves the functioning of national banking markets, with positive welfare implications for banking customers and with positive overall welfare implications for the domestic economy. An interesting finding is that the number of entrants matters more than their market share (Stijn Claessens, Asli Demirguc-Kunt, Harry Huizinga, 1998).

Panel data analysis identifies the strengths and weaknesses for the organizational arrangements for banking in emerging markets, finding that, most importantly, foreign banks bring the advantages of their

ability to tap the external liquidity of their parent banks, to lower the cost (risk) of deposits, and to improve banking stability (Atif Mian, 2003). The entry of foreign banks brings large benefits to host countries' financial systems and their economies at large: efficiency gains stem from new technologies, products and management techniques, as well as from competition simulated by new entrants and from more stable funding and lending patterns (Juan Cardenas, Juan Pablo Graf, Pascual O'Dogherty 2003). Studies of European transition countries reveal that foreign-owned banks have become major players in the financial systems of those countries, although foreign bank presence and financial development in general vary considerably across transition economies. In general, foreign-owned banks are more profitable than domestic banks, but it appears that, as time passes, the performance of foreign and domestic banks tends to converge (Ilko Naaborg, Bert Scholtens Jakob de Haan, Hanneke Bol, Ralph de Haas, 2004).

Other case studies show that, since 1997 when Mexico allowed foreign banks unrestricted entry to the local market, the impact of foreign mergers and acquisitions on Mexico's banking system has resulted in both foreign and domestic banks becoming increasingly risk averse. And foreign banks are more profitable than domestically owned banks because their market power allows them to charge higher service fees than domestic banks (Stephen Haber and Aldo Musacchio, 2005). The acquisition of local banks by foreign banks has not created a persistent bias towards large multinational corporations in these banks' lending. Instead, increased competition and the improvement of subsidiaries' lending technologies have led foreign banks gradually to expand into the small and medium enterprises and retail markets (Ralph de Haas and Ilko Naaborg, 2005). Another interesting finding is from a large panel study of Eastern European economies to assess the differential impact of foreign bank lending on firm growth and financing. Foreign lending stimulates growth in firm sales, assets, and leverage, but the effect is less pronounced for small firms. However, foreign banks can help mitigate connected lending problems and improve capital allocation; younger firms receive more loans with lower financial expenses where foreign bank entry is stronger. In contrast, connected firms, usually larger firms, receive fewer loans, grow more slowly and pay a higher interest rate on their financial debt when foreign bank presence becomes more pervasive (Mariassunta Giannetti, Steven Ongena, 2007).

To date, theoretical research and empirical findings support the view that the internationalization of financial services in emerging economies and foreign bank entry to developing host countries have a substantial positive impact. However, several interesting questions remain unanswered. For example, do foreign banks benefit firms only directly through their lending, or are there also indirect positive effects on

domestic banks' efficiency? If China is seen as a typical example, what is the strategy that drives banks' FDI in China? If the number of entrants matters more than their market share, does this indicate that foreign banks promote competition between local banks upon entry rather than after they have gained substantial market share? After China introduced new supervision rules for foreign banks effective from December 11th 2006, did this action stimulate foreign banks' interest in acquiring (part of) China's local banks?

This study considers some of these questions in the context of the role of foreign banks in China's banking sector. The research traces patterns associated with various strategies adopted by foreign banks over a 30-year period, and endeavors to identify the competitive advantages and disadvantages of foreign and domestic banks by examining the performance of some representative banks over time.

3. Foreign bank's FDI in China since 1978: a brief historical perspective

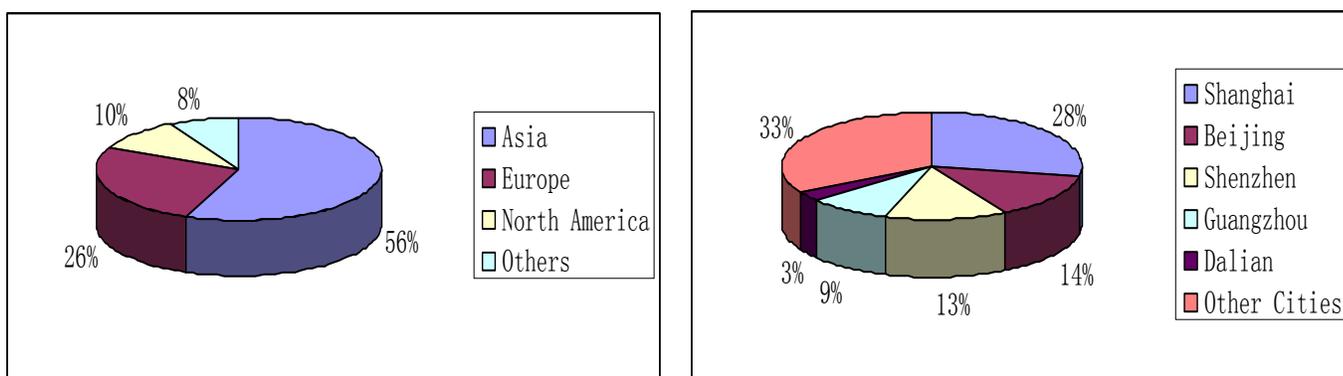
Reform of the banking industry might prove to be the most challenging aspect of China's economic transition. Chinese banks need to internalize the best practices of the international financial market, as they make effective commercial operation their priority, seeking ever greater efficiency along with better protection from systemic risk. In theory, the entry of foreign banks appeals as perhaps the best of alternative ways to enhance the soundness of China's banking system. In practice, however, foreign entry can raise sensitive and delicate political issues; at least to some extent, people may experience discomfort over the entry of foreign banks, especially at the outset. That explains why many emerging markets impose restrictions on the activities of foreign banks. But that is a short-sighted view. By identifying foreign entry as an opportunity for a beneficial restructuring of the banking system overall and not just as a competitive threat to local banks, there could be greater public appreciation for the contributions of foreign participation in supplying better quality financial services. Developing countries generally would help themselves by welcoming foreign banks. China chose this path as it opened its door in 1978, although movement was exceedingly slow until the beginning of the new century. As one of the biggest developing countries, China's rapid economic growth and enormous market potential, as well as the extensive existing bank distribution networks, all contributed to the attractiveness of investment in China by foreign financial institutions.

The mode of foreign bank entry to China

Foreign banks can enter China in one or more of four ways: by establishing a wholly foreign-owned bank, by opening a branch or representative office, by entering into a joint venture with a local

partner, or by acquiring an equity share in an existing Chinese bank. Restrictions on foreign bank activities, now lifted after WTO accession, meant that establishing branches has been the most popular mode of entry for foreign banks; most of them being established in the major financial centers: Shanghai, Shenzhen, Beijing and Guangdong. By the end of 2006, 74 foreign banks from 22 countries and regions had established a total of 200 branches and 14 operating institutions in China. In all, 186 foreign banks from 41 countries had set up 242 representative offices in the country.² The top six sourcing countries or regions are Hong Kong (99), USA (26), UK (21), Japan (19), Singapore (17), and France (15); together they account for about two thirds of all foreign banking institutions in China.

Figure 1 & 2: Foreign banking operating institutions by sourcing economies and by regions in China (end 2006)



Source: China Banking Regulation Commission, Annual Report, 2006.

According to the relevant rules and regulations, foreign bank branches, wholly foreign-funded banks and joint venture banks, as operating institutions that can conduct the business of deposits, lending, settlement and insurance, may apply for RMB services. By the end of 2006, RMB business licenses had been granted to 115 foreign banks. Total assets of foreign banks (RMB and foreign currencies together) amounted to RMB 927.9 billion, accounting for 2.1 percent of the total assets of the Chinese banking institutions (Table 2).

Table 2: Foreign bank operating institutions and assets from 2003-2006

Items	2003	2004	2005	2006
Numbers of business offices	192	211	254	312
Assets (RMB 100 million)	4159	5823	7155	9279
Share of banking sector (%)	1.50	1.84	1.91	2.11

Source: CBRC Annual Report, 2006.

² <http://www.cbrc.gov.cn>.

Although 12 years have passed since 1996 when the regulator approved the participation of overseas institutions in Chinese banks, foreign bank direct investment in China, including strategic investment in Chinese banks, picked up momentum only after 2001, when China joined the WTO. Thereafter, emphasis shifted from establishing branches to acquiring equity in China's state-owned banks as well as shareholding banks and city banks.

As the Chinese government has relaxed constraints on foreign bank entry to its market, acquiring equity in domestic banks has become an attractive option for foreign banking/financial groups seeking to penetrate China's banking industry. Through June 2005, foreigner's holdings of shares of domestic banks were valued at about US\$6.5 billion; in the second half of that year, the value of shares acquired by foreign investors reached \$10 billions. Fifty percent more foreign capital flowed into the sector in six months than in the previous decade, mainly because three of China's biggest SCBs, namely the Bank of China (BOC), the China Construction Bank (CCB) and the Industrial and Commercial Bank of China (ICBC) introduced foreign financial groups as strategic partners. By the end of 2006, Chinese commercial banks had formed partnerships with 29 foreign institutional investors with a total foreign investment of US\$19 billion. Among the foreign institutional investors, 18 banking institutions account for 62.1 percent of total investment; 3 investment banks account for 10.4 percent; and 8 other types of institutions account for 27.6 percent. Foreign banks enjoy their local partners' advantages such as extensive branch networks and a huge potential market. And the local partners expect foreign investors to introduce not only additional capital, but also management technology, business operating skills, and professional knowledge as the CBRC makes clear in approving foreign investors' participation in Chinese banks.

The boom in foreign bank entry to Shanghai and other major coastal cities

An interesting aspect of foreign financial institutions' direct investment in China is its lack of balance. The east and a few big cities are overwhelmingly the favored locations of foreign banks, because they are more developed economic areas with greatly improved basic infrastructure, institutional quality and market efficiency. Foreign bank participation is regionally unequal, with most banks establishing branches in the more open and economically developed cities by the coast such as Shanghai, Beijing, Tianjin, Guangzhou, and Shenzhen.

Shanghai is the location most favored by foreign banks. Establishing Shanghai as an international financial center in the long run has been a mainstay of the national financial strategy, possibly influenced by Singapore's accomplishments in this regard. Within recent years, Shanghai has emerged as the pre-

eminent domestic financial center of China with the best developed financial institutions and supporting infrastructure for the financial system, the biggest foreign exchange market, an emerging discount market, an active inter-bank credit market, the country's most mature securities' market, and a substantial insurance market. Shanghai has the largest national share in a host of important asset markets, including mortgage lending, commodity futures, and precious metals and gems (silver, gold and diamonds). Currently, almost all large domestic banks and non-bank financial institutions have branches and/or head offices or representative offices in Shanghai. As well, the Shanghai branch of the PBC reported that foreign financial institutions had established 106 offices in Shanghai by the end of 2006. Shanghai leads the way in the number of financial experts, the volume of available financial information, and the quality and quantity of specialized financial technology.

Shenzhen, with its proximity to Hong Kong and Taiwan, also appeals as a potentially important financial center. Investment from both territories is concentrated in Shenzhen and foreign investors create a substantial demand for financial services. Foreign financial institutions have considerable incentive to follow their customer-enterprises from these two regions. In this way, as a major host for FDI in mainland China, Shenzhen is a natural gateway for the entry of foreign banks.

Moreover, as China's capital and the host of the Olympic Games in 2008, Beijing also is a magnet for foreign financial institutions, and there is a queue of them waiting to register for entry to the Beijing market. As well, many foreign banks are now eager to upgrade representative offices to branches. Some other major cities, notably Guangzhou, Tianjin, Xiamen and Dalian, also are experiencing rising numbers of foreign banks entering their local markets.

The origin of the foreign banks recently entering China mainly reflects two factors: first, the history of economic and trade relations between China and the country of origin -- Japan, Germany, Hong Kong and Singapore are typical examples of well-developed commercial relations with China; and, second, the size and global reach of the foreign bank. In particular, the global strategy of the large multinational banking groups cannot ignore China, with its rapid economic development and increasing financial openness. In addition to the spur from close trade linkages, the pre-eminent status of the financial service providers of, for example, France, the USA, the UK, Japan and Hong Kong, essentially mandate their participation in the Chinese economy. Of course, as a comparative new-comer to WTO membership, China also attracts the attention of foreign banks from a host of different countries by virtue of the market opportunities newly created by the opening of China's financial sector (Table 3).

Table 3: Foreign bank direct investment in China by sourcing countries or areas (end-2006)

Country or Area	Number of banks/branches	Country or Area	Number of banks/branches	Country or Area	Number of banks/branches
Hong Kong	14/56	Holland	3/7	India	2/2
Germany	7/10	Canada	3/6	Australia	1/2
Korea	6/18	Thailand	3/6	Norway	1/1
USA	6/15	Italy	3/3	Portugal	1/1
Japan	5/19	Belgium	2/5	Philippine	1/1
France	4/15	Sweden	2/2	Austria	1/1
Singapore	3/14	Switzerland	2/2	Malaysia	1/1
U.K.	3/13			Total	80/200

Source: Foreign bank regulation monthly report, December 2006, China Banking Regulatory Commission.

In addition to expanding foreign exchange deposits and loans, foreign banks have also been expanding the range of products they offer in the Chinese market. At present, foreign bank business lines comprise financing activities, financial consulting, investment banking, international settlement, guarantee activities, remittance transfers, foreign exchange transactions, discount bills, securities underwriting services, and more. Foreign banks were permitted to conduct limited business activities in local currency beginning in Shanghai in 1997, and then, also to a very limited extent, in Shenzhen in 1998. As a major concession for WTO accession, China agreed fully to open the domestic banking sector to foreign banks from December 11, 2006³; foreign banks would be accorded national treatment and compete with domestic banks on an equal playing field thereafter. Most restrictions on foreign banks' activities in China had been removed by the beginning of 2007.

Implementing China's WTO commitments: challenges to domestic banks

Traditionally, the staff at China's SCBs devoted little attention to their customers, due partly – one suspects – to the effective monopoly the SCBs jointly enjoyed in the financial sector. State-owned banks had no need to attract customers by offering new services or improving their existing services. As an example, many of China's bankers still regard high levels of deposits as their business goal; if the stock of deposits rises, good performance is assumed. They pay little attention to pricing loans or credit-

³ www.gov.cn, Xinhua News Agency, 12/11/2006.

assessment; unlike real bankers, they have no great need to allocate finance appropriately or make profits. There is no denying that things have improved, with the culture of credit creation slowly changing, but, even after 10 years of emphasizing that banks have to transition from politically motivated institutions to modern corporations driven by commercial considerations, problems are unresolved. Riedel's (2006) observations about Chinese firms: "the main objective of China's state-owned and state-dominated firms is not to maximize profit but instead to maximize investment growth and the drive for expansion. This is only rational since the reward to bureaucrats who manage state-owned and state-dominated enterprises is not the profit they earn, but mainly the prestige, power and accompanying perks they derive from commanding an organization, which are all the greater the larger the organization." applies equally to banks. China's SCBs still seem fixated on the expansion of deposits, which are taken as a symbol of prestige. Improving banks' performance requires a change in these views, along with essential upgrades of management techniques and skills.

The liberalization of the capital market is an ongoing and essentially irreversible process. Within an environment of financial globalization, the SCBs need to become much more customer-focused in order to compete with new external entrants. China's banks are accustomed to surviving with the protection of the government; the removal of their protective umbrella will compel them to face increasing competition to survive in China's newly globalized financial system.

From "ticking time bomb" to "hot property"

Since the primary source of financing for China's state-owned enterprises has been through SCBs plagued by poor lending practices and poor corporate governance, the Chinese banking industry, and especially its serious problem with non-performing loans, has been viewed as a ticking time bomb for China's financial system. For China's banks to be viable, they must be able to compete on a global stage, and respond to the pressure of foreign competition (Stewart Myers, 2002). This opinion became widely accepted after China acceded to WTO membership in 2001. But things have been different since 2004, a period that officials have viewed as a most important one that offers the chance still to seize the high ground of the domestic banking industry, despite some risks that exist in endeavoring to do so. The WTO transitional period ended in December 2006, as China started to implement its commitment from the beginning of 2007, including by stepping up its banking industry reform. China is witnessing the biggest expansion of foreign banks' participation in the restructuring of the banking industry since 1978, with the explosion of foreign strategic investment a typical example.

From 2001 to June 2006, 26 foreign banks made strategic investments in 22 Chinese banks. These foreign strategic investments appeal as a potentially effective way to further China's on-going banking reform and to build a healthier, more stable, and more efficient modern banking system. Foreign investors are attracted by China's rapid economic growth, enormous market potential and the opportunity to leverage local banks' name recognition, customer bases and distribution networks. Equity positions in existing banks also offer foreign investors potentially attractive financial upside if the invested banks significantly improve their operations and performance over time (Hope and Hu 2006). However, this possibility needs to be validated by experience; comparative case studies that will determine how successful is the outcome of strategic investment await the data from several post-investment years.

4. Comparative study of Chinese banks with or without foreign strategic partners

This section reports on the results of comparative case studies of Chinese banks that have attracted foreign strategic investment and those that have not.

a. Sample description

The Chinese banking industry has been diversifying since the 1980s. At the end of 2006, the banking system comprised the Central Bank of China (PBC); three policy banks: the National (State) Development Bank of China (NDB), the Agricultural Development Bank of China (ADB) and the Export and Import Bank of China (CEXIM); 11 shareholding banks; four large state-owned commercial banks (SCBs);⁴ and 252 foreign banks/agencies (among them, nine had already registered in China as single venture corporations by 2007; others are foreign bank branches and representative offices). There are also 180 city banks and numerous rural banks and credit cooperatives.

According to CBRC, through the end of 2006, banking institutions within Chinese territory held total assets of RMB 43.1 trillion yuan, an increase of 17.3 percent from the figure a year earlier. By accounting convention their liabilities were the same, with equity rights comprising RMB 2.24 billion yuan, an increase of almost 40 percent from a year earlier. Classified by ownership status, SCBs still hold more than half of the total assets (52 percent), shareholding banks hold 16 percent, rural financial associations (RFAs) hold 10 percent, policy banks (PBs) 8 percent, city commercial banks and credit

⁴ Usually, the Bank of China (BOC), the ICBC, the China Construction Bank (CCB), and Agricultural Bank of China (ABC) are regarded as the big four state-owned banks, although three of them have become shareholding banks with foreign bank investment. The foreign ownership shares are small and the state share predominates. The Communications Bank (BOCOM) is also defined by the CBRC as a state-owned bank but, since it was set up in 1980s as the first shareholding bank, we denote it as shareholding bank in this paper.

associations (CCB&A) 6 percent, postal savings (PS) 4 percent, and foreign banks and non-financial institutions (NFI) each 2 percent (figure 3). Among these, the shareholding banks' asset share has expanded faster than the shares of the others, with the second fastest expansion recorded by CCB&A

In this study, to compare the performance of banks with strategic investment with that of those without strategic investment, we sample banks that publish annual financial reports and divide them into three groups: the first comprises SCBs; it includes the four large state-owned banks although three of them have become shareholding banks in recent years. Group 2 comprises nine shareholding banks, including the Bank of Shanghai, which is the biggest city commercial bank; seven of them have foreign investment partners and two do not.

Table 4. Foreign investment in Chinese banks

Year	Bank	Foreign investor(s)	% foreign ownership
2001	Bank of Shanghai	HSBC/IFC/Shanghai Commercial Bank	8/7/3
2002	Bank of Nanjing	IFC/BNP Paribus	15/19.2
2003	Shanghai Pudong Development Bank	Citigroup	4.6
2004	Bank of Communications	HSBC	19.9
	Industrial Bank	Hang Seng Bank/IFC/GIC	16/4/5
	Shenzhen Development Bank	Newbridge/General Electric	17.9/7.3
	Xian City Commercial Bank	Bank of Nova Scotia/IFC	12.5/12.4
	China Minsheng Bank	IFC/Temasek	1.1/4.6
	Jinan City Commercial Bank	Commonwealth Bank of Australia	11.0
2005	Bank of China	Royal Bank of Scotland/UBS/Temasek/ADB	9.6/1.6/4.8/
	China Construction Bank	Bank of America/Temasek	8.5/6.0
	Bohai Bank	Standard Chartered	19.9
	Hangzhou City Commercial Bank	Commonwealth Bank of Australia	19.9
	Bank of Beijing	ING Groep NV/IFC	19.9/5
	Nanchong City Commercial Bank	German Investment and Development Bank	13
2006	Industrial and Commercial Bank of China	Goldman Sachs, Allianz and American Express consortium	8.5
	Huaxia Bank	Deutsche Bank/Sal Oppenheim Jr	9.9/4.1
	Guangdong Development Bank	Citigroup/IBM	20/4.74
2007	Dalian City Commercial Bank	SHK Financial Group	10

Source – Leigh and Podpiera (2006), news reports.

Notes – The equity shares referred to above list the original stake purchased by the foreign investor. Some banks have received foreign investment from different sources at different times. For example, IFC originally acquired a 15 percent share of Bank of Nanjing in 2002. BNP Paribus then arranged to take a 19.2 percent stake in the same bank partly by negotiating with IFC to buy two-thirds of IFC's 15 percent.

The main financial indicators used for comparison purposes are as Table 5 shows. The “balanced score card” (BSC)⁵ is a popular metric used world-wide since the 1990s to measure bank performance. However, banks in China have begun to use this metric only since 2006; currently it is an inappropriate indicator for

6. The BSC was first created by Robert Kaplan and David Norton in 1992. It includes financial indicators such as the net assets return ratio, the cost and expense return ratio, the non-performing loan ratio, the operating return growth ratio, and the mean profit growth ratio. Such non-financial data as customer's satisfaction, and internal process and innovation capability supplement the financial information.

the comparative performance of Chinese banks. Table 5 indicates some of the performance indicators used to evaluate Chinese banks, some of which have targets set by the regulatory authorities (China Banking Regulatory Commission -- CBRC). The TA, TD and TL (see definitions in the Table) are the usual indicators of market share for China banks; TP, NP, ROAA and ROAE are used to assess their profit-making capability; and NPL, RIC ⁶ and CA indicate their capacity to evaluate and manage risk. Table 5 shows the regulatory standards that the CBRC applies to the risk-related indicators.

Table 5: Financial indicators used to compare different banks

Term		Term		Regulation Requirement
TA	Total assets	ROAA	Return on total assets	
TD	Total deposit	ROAE	Return on average share	
TL	Total loan	NPL	Non performing loan	<4 %
TP	Total profit	RCI	Reserve cover loss ratio	≥60%
NP	Net profit	CA	Capital adequacy	≥8 %

Note – The CBRC stipulated the requirements for NPLs and CA on 12/31/2005, and for RCI for SCBs on 4/18/2006.

The data used here are mainly from the sample banks’ annual financial reports, augmented by some data from such different channels as the CBRC, bank managers, and published articles. Since most banks in China are still in the process of consolidating their accounting standards, information disclosure is less than complete across banks, even with the restricted sample used in this paper. Missing numbers indicate problems with data collection rather than performance issues within these institutions.

B. Comparative study and analysis

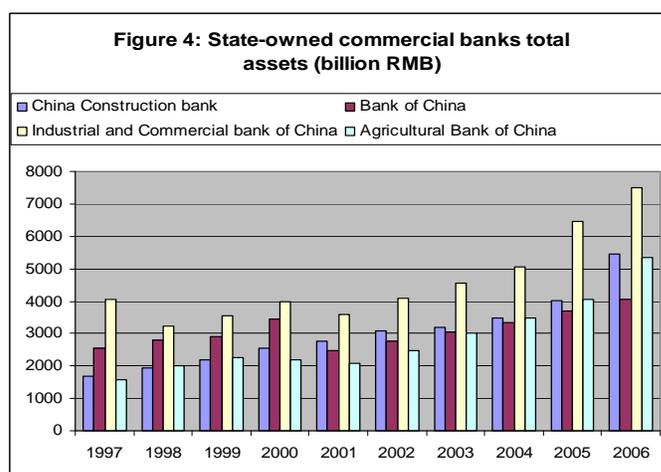
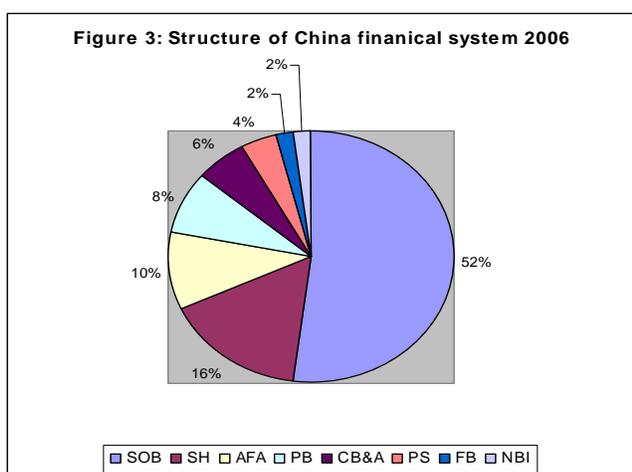
Former state-owned commercial banks

Of the four biggest SCBs, the BOC and the CCB transformed themselves into shareholding banks in 2004, and the ICBC did the same in 2005; they attracted their foreign strategic partners in the following year. The BOC and the CCB received identical, large capital injections at the same time in 2004: US\$ 22.5 billions each. Their total assets were similar at that time. According to their recent annual reports, both banks maintained rapid growth of assets and profits through 2006, when for the first time they issued financial reports consistent with international accounting principles. The BOC’s total assets reached RMB 5.33 trillion yuan (Figure 4) in 2006, an increase of 12.4 percent over 2005; total deposits and loans increased 10.6 percent and 9 percent, respectively (Figures 5 and 6), during the same period. Equity rights

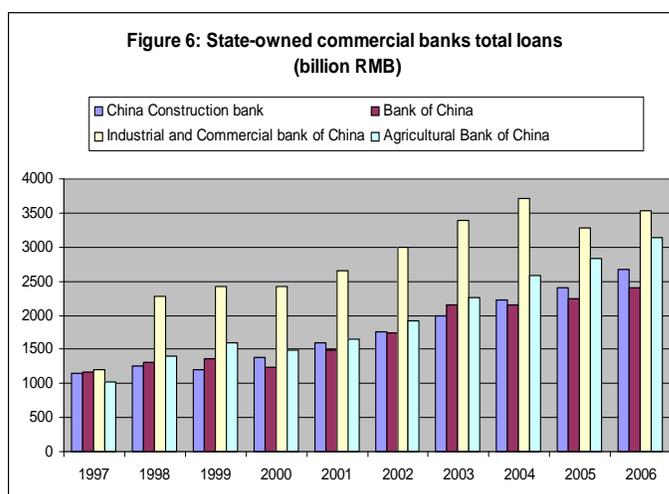
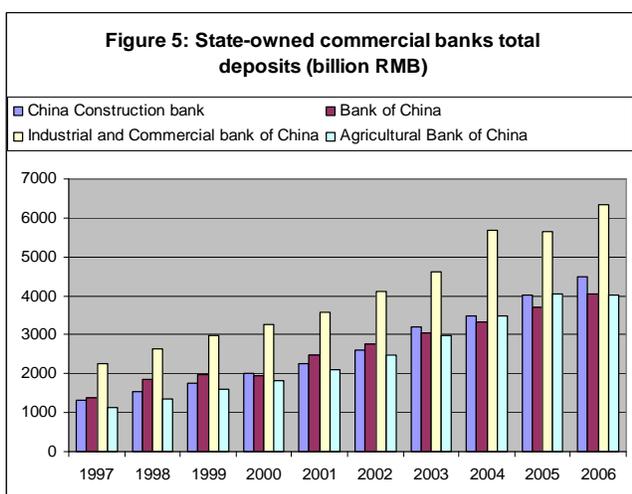
⁶ Reserve cover loss ratio –RCI is that a bank keep reserve in order to make up its NPL.

increased 66.1 percent, and net profits expanded to RMB 41.6 billion yuan (Figure 9). These main indicators of performance show obvious improvement, The IPO in Hong Kong and Shanghai enhanced BOC's capitalization; the \$22.5 billion addition to capital improved its capital adequacy and added strength to the balance sheet more generally.

At the same time, the CCB, which raised \$9.2 billion in 2005, seems to have experienced a year-on-year decline in its return on assets and capital adequacy, apparently because the Construction Bank no longer enjoyed a tax exemption in 2006 as it had in 2005. Nevertheless, the CCB did perform better in terms of net profit, the return on assets, the cost and income ratios, and the non-performing loan ratio.



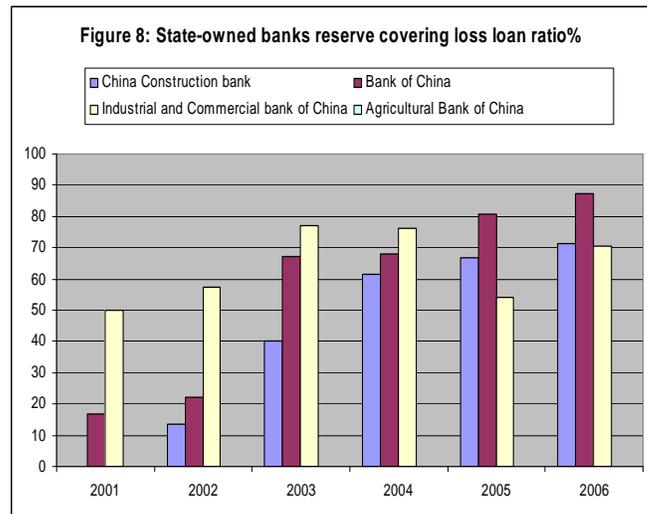
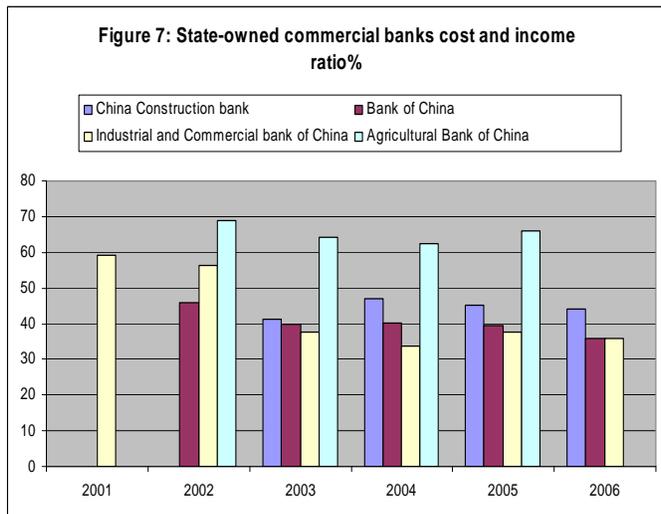
Source: China Financial Year Book: 1997-2005. Annual reports of banks: 1997-2006.



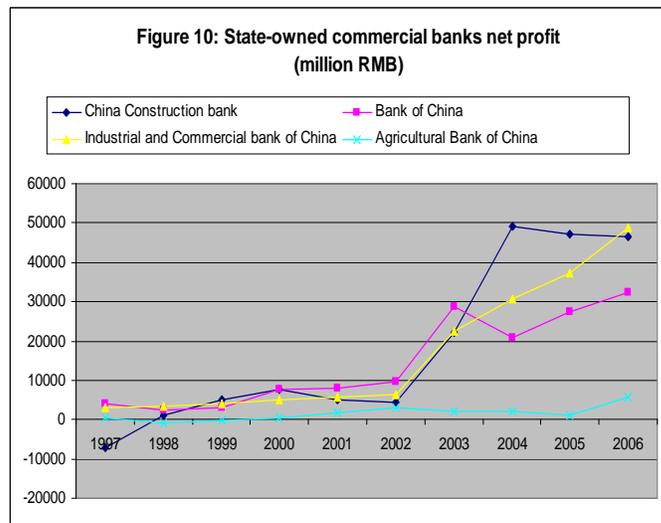
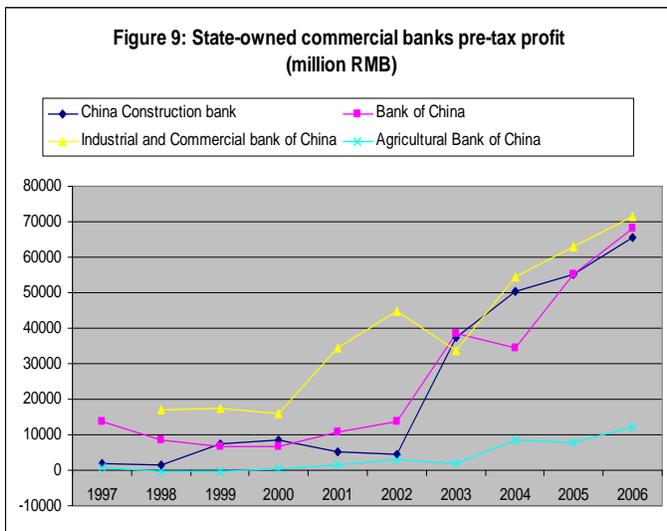
Source: Source: China Financial Year Book: 1997-2005. Annual reports of banks: 1996-2006.

The non-performing loans of the Bank of China fell as its net profit rose; and the reserve cover to loss ratio rose from 81 percent to 87 percent (Figure 7), excluding the general reserve of RMB 9.4 billion

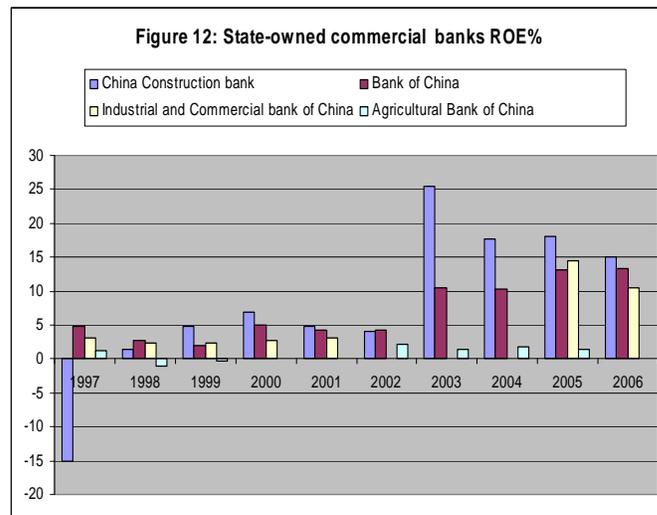
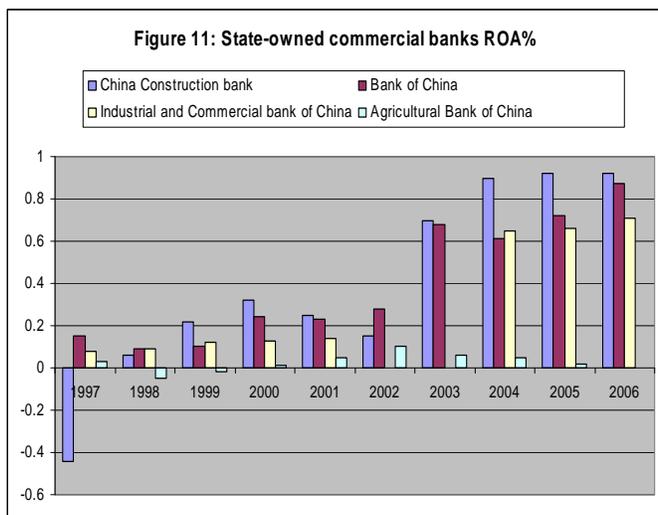
yuan after taxation. These outcomes are better than those of the Construction Bank although BOC's ROAA, ROEA, CA and NPL are not as good as CCB's (Figure 8). That is at least partly because the BOC gives greater weight to market risk when it calculates its CA (allocates proportionally more assets to reserves to cover potential losses).



Source: China Financial Year Book, 1997-2005. Annual report of each bank 1997-2006.



Source: Annual reports of each bank. China Banking Association, 2006.



Source: China Financial Year Book: 1997-2005, Annual reports of each bank: 1997-2006, and authors' calculations.
 Note: In 2002-2003, there were some adjustments to the accounting systems; this is why the ratio rose abnormally.

When we examine the composition of income of these two banks, the paths by which they increased assets and profits differ. The BOC's total lending in 2006 was RMB 2.41 trillion yuan, 46 percent of total assets and 7.7 percent greater than in 2005. The Construction Bank's lending grew 14.5 percent over the same period to RMB 2.68 trillion yuan, or 54.5 percent of its total assets. That suggests that the CCB still sources its main operating income from traditional activities, i.e. interest income, which is 20 percent higher than that of the BOC. By contrast, the BOC's generates more than 21 percent of its operating income from sources other than interest; the corresponding figure for the CCB is only 6 percent. The diversification of sources of profit in the BOC should work to its advantage in a more competitive market.

Foreign strategic investors played a very important role when SCBs initiated their foreign IPO process. Credible investors helped boost market confidence in the disclosures in the prospectuses distributed ahead of the IPOs, and contributed to the highly successful IPO of the CCB in Hong Kong. Moreover, for potential stockholders, the entrance of strategic foreign partners could be expected to improve the CCB's performance in a host of areas: overall governance, management mechanisms, internal auditing, adoption of a credit culture, and improved risk-assessment techniques. As well, FDI in the banks clearly had the potential to transform China's banking industry, and more generally to foster the development of an efficient, competitive financial system. These "external effects" augment the benefits obtained from the "internal effects," including raising operating incomes and lowering operating expenses.

Although capital enhancement is an urgent requirement for Chinese banks, the more important contribution sought from strategic investment is improved corporate governance within the Chinese banking industry. China's domestic banks did establish governance procedures and adopted organizational structures similar to those found in leading international banks, but many years of executive intervention made adaptation to new rules difficult and reversion to old ways all too easy. The hope kindled by introducing foreign strategic investment is that bank corporate governance will be enhanced not just in the abstract but in practice.

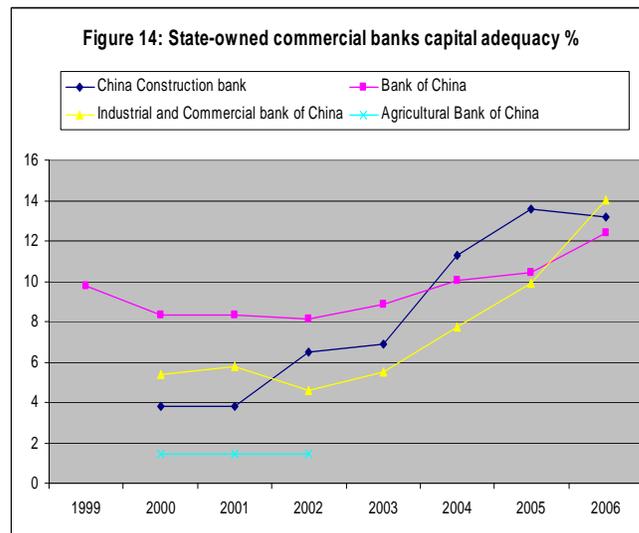
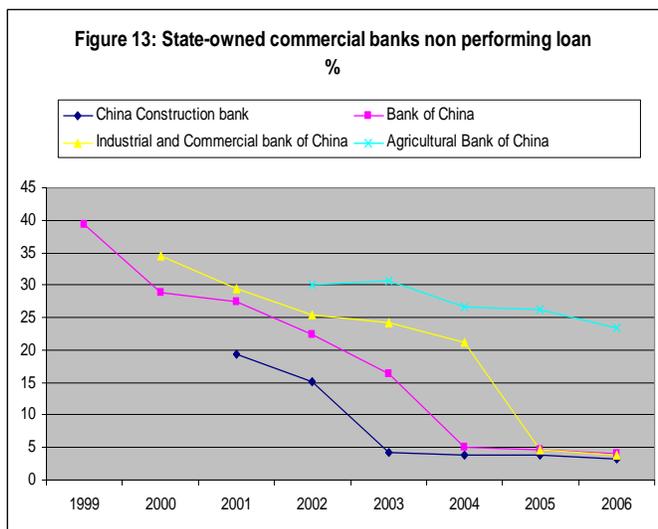
One case in point, as the main strategic investor in the CCB, the Bank of America (BOA) sent 50 professionals to help counterparts in the Construction Bank to develop individual customer service, which is one of BOA's most successful activities and one that the CCB most needs to target over the coming one or two decades. Since September 2005, the two banks have cooperated in implementing an agreement that involves upgrading the CCB's worldwide financial services, retail operations, electronic bank services, information techniques, management of human resources, assets and liabilities, and other activities. Their cooperation can be extended through 2012 to cover more than 20 projects. Among them, the CCB emphasizes management of its financial service quality, and the introduction of the Six Sigma quality control system⁷. This system is the first to be established in the domestic banking system; it could serve as a model for others. The Bank of America also provides a range of training programs for the staff of the CCB.

At the same time, the Construction Bank has expanded its activity abroad, and has acquired all of the Bank of America (Asia) Limited in Hong Kong, thereby doubling the size of the CCB's operations in Hong Kong and elevating its customer loan ranking from 16th to 9th. This acquisition could be a gateway to further expansion abroad. Essentially, strategic foreign investment is proving to be a complex process that begins with the introduction of additional capital and continues with the development of banking expertise; the domestic partner bank enhances its market competitive capability in this way, which in turn drives its transformation into a modern commercial bank.

Foreign strategic investment in the CCB and its subsequent IPO are watershed events for both China's banking system reform and the role of Chinese SCBs in the global financial market. These events also demonstrate the determination of the central government to construct more sophisticated and transparent markets for financial services and capital in China. The entry of the SCBs into the

⁷ Six Sigma, at many organizations, simply means a measure of quality that strives for near perfection. Six Sigma is a disciplined, data-driven approach and methodology for eliminating defects (driving towards six standard deviations between the mean and the nearest specification limit) in any process -- from manufacturing to transactional and from product to service.

international financial market subjects them to the supervision of both national and international regulators, as well as to the scrutiny of domestic and foreign investors. Ultimately, the internationalization of China's banks should put paid to the old system that continued to create non-performing loans even after the banks became shareholding companies. There are already hopeful signs that the reformed SCBs are beginning to adhere to commercial principles in their operations as shown in Figures 13 and 14.



Source: China Financial Year Book: 1997-2005. Annual reports of banks: 1997-2006.

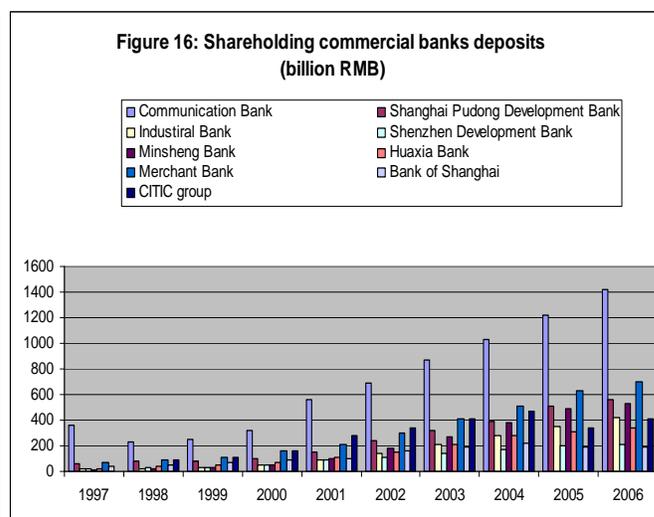
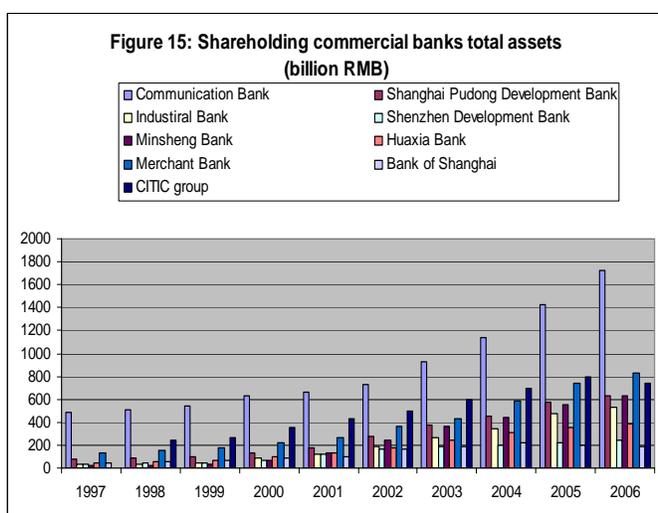
According to the five-level standards for loan classification,⁸ the CCB, BOC, and ICBC reduced their non-performing loan from 5.7 percent, 22.5 percent, and 25.4 percent respectively in 2002 to 4.0 percent, 4.1 percent and 3.9 percent respectively, in 2006. The ICBC was the third of the large SCBs to introduce foreign strategic investors, partnering with Goldman Sachs, Allianz, and American Express. By June 2006, only a few months after the investment, there were reports that (i) Goldman Sachs had suggested several measures both to improve risk management and to set up an information system to support it; and (ii) had proposed such new financial products and services as derivatives, money-market funds, and offshore capital management, in addition to some methods to deal with non-performing loans. By the end of 2006, the total market value of ICBC reached about \$210 billion, ranking third after Bank of America and Citibank amongst all global banks.

⁸ The regulation of China Banking Regulatory Commission demands all commercial banks in China adopted international standards for loan classification in 2004, which includes on balance-sheet loans (regular loans) and off-balance sheet loans (Letter of Credit, Acceptance, Guaranteed loan, and loan commitment). All commercial banks must submit their reports about non-performing loans based on this classification, according to their overdue 90, 180, 270, 360 and 360 more respectively.

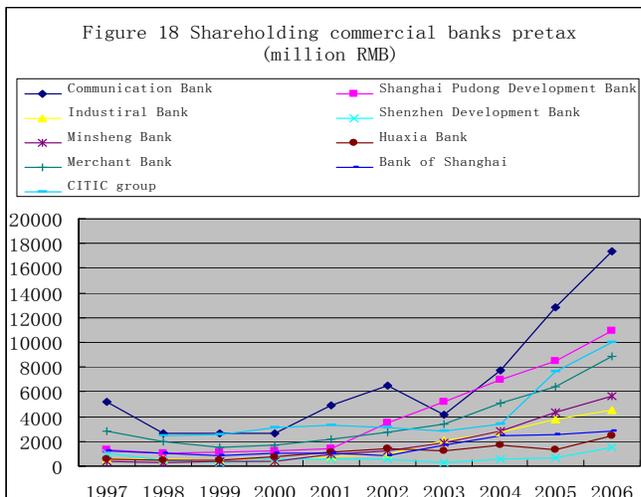
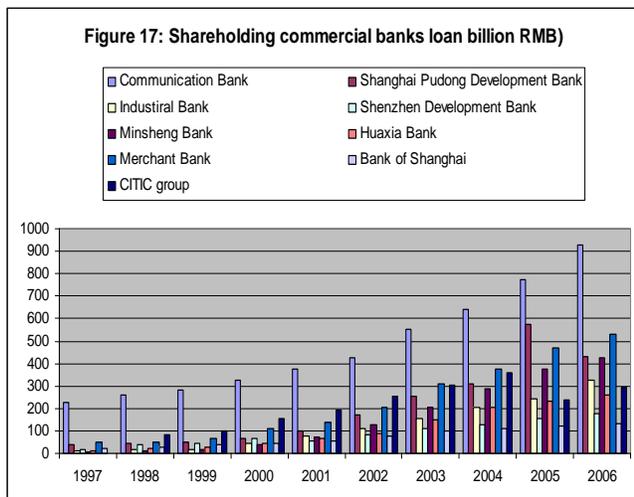
Shareholding commercial banks

There were 12 shareholding commercial banks in China in 2006. The largest of these, BOCOM, was the first national state-owned shareholding commercial bank. It was established in 1987 as an experiment in Chinese financial reform; and it was also the first bank to introduce foreign strategic investment in 2004. A successful IPO in Hong Kong followed in June 2005. Almost all of its financial indicators confirm its ranking as number one in size (Figure 15); its net profits and capital adequacy ratio are considerably better than its competitors. Its cooperation with Hong Kong Shanghai Banking Corporation (HSBC) and other domestic strategic investors has enabled BOCOM essentially to complete its transformation into a modern financial enterprise by improving its risk management, internal auditing, capital management, and human resource management.

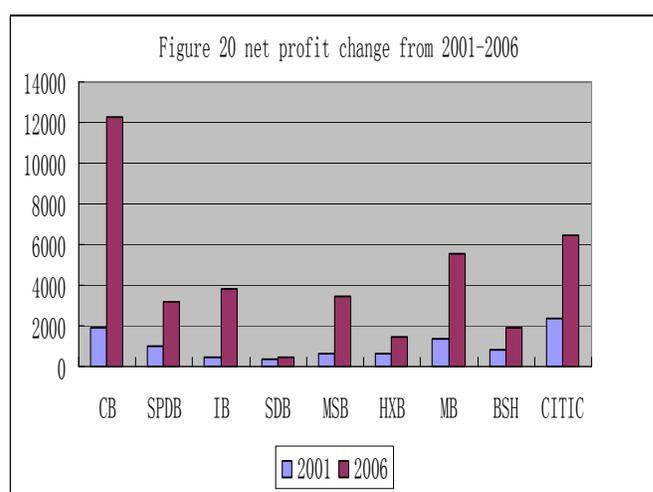
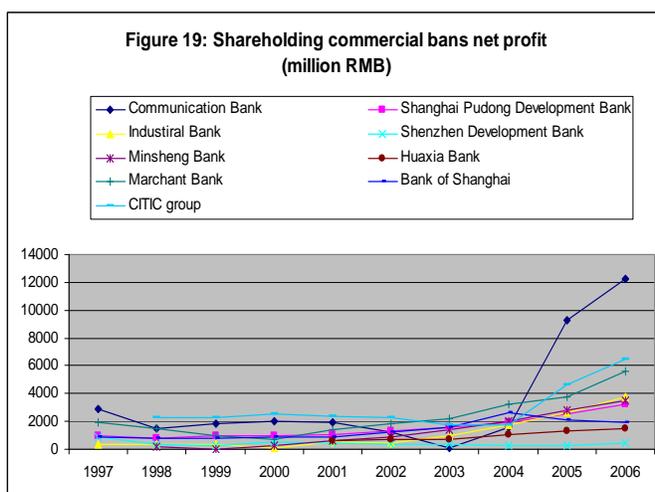
The other shareholding commercial banks have demonstrated sustained positive development since 2001, under pressure from both needed domestic reform and external challenges due to WTO accession. Most of these banks have sought partnerships from abroad in their pursuit of the same targets for improved performance described above for the SCBs. Some of them – e.g. Shanghai Pudong Development Bank, Minsheng Bank and Huaxia Bank -- have achieved excellent performance; some have done less well, with Shenzhen Development Bank being a typical example. Data are unavailable from the sample of city commercial banks, the exception being the Bank of Shanghai, and its size and other characteristics resemble those of the shareholding banks, so is included with that group (Figures 15-17).



Source: China Financial Year Book: 1997-2005. Annual reports of banks: 1997-2006.



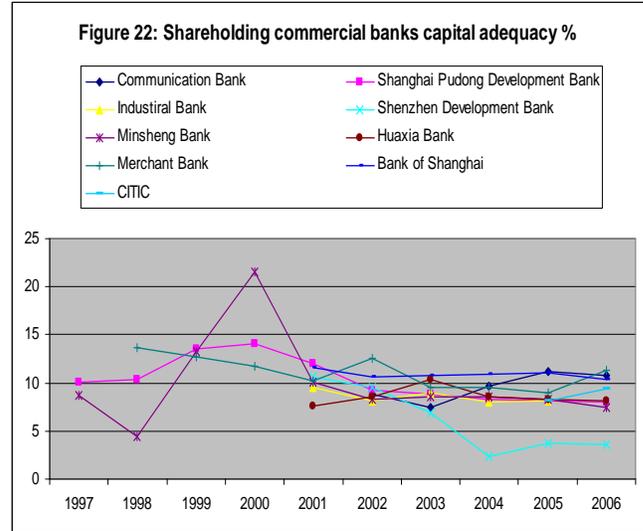
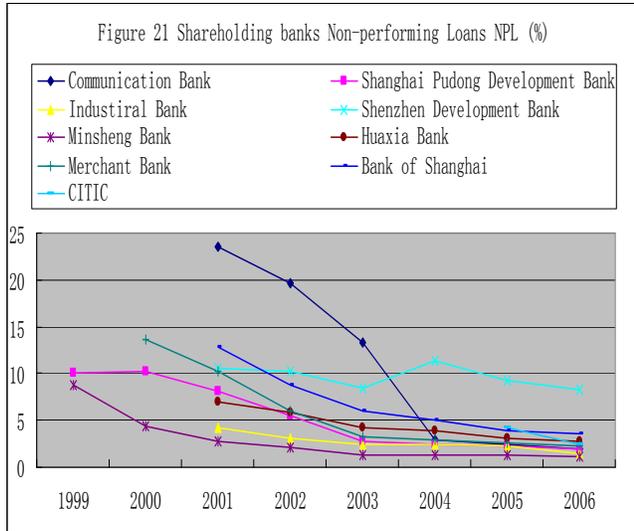
Source: China Financial Year Book: 1997-2005. Annual reports of banks: 1997-2006.



Source: China Financial Year Book: 1997-2005. Annual reports of banks: 1997-2006.

Note: CB-Communication Bank; SPDB-Shanghai Pudong Development Bank; IB-Industrial Bank; SDB-Shenzhen Development Bank; MSB-Minsheng Bank; HB-Huaxia Bank; MB-Merchant Bank; BSH-Bank of Shanghai.

The figures show that most shareholding banks, plus the biggest commercial bank – Bank of Shanghai, have expanded their domestic market shares since 2001, when the first foreign strategic investments occurred. Their net profits increased dramatically over 6 years, especially those of BOCOM. The SDB is something of an exception in Figure 19; its performance is less good than other banks', which can be seen also in Figures 21 and 22. Most shareholding banks reduced their NPL-ratio gradually but substantially since 2001, with stable ratios of both NPLs and capital adequacy (complying with CBRC regulations) after 2004. The Shenzhen Development Bank, by contrast, continues to suffer from a high ratio of NPLs and capital inadequacy.



Source: China Financial Year Book: 1997-2005. Annual reports of banks: 1997-2006.

Domestic shareholding commercial banks (DSCBs) in China expect to utilize foreign banks' expertise to introduce advanced management techniques that will improve their corporate governance. Strategic partners also should help to develop new products and services for the DSCBs; of course, they provide supplementary capital as well. Doubtless, in negotiating the terms of engagement foreign strategic investors promise to supply what the local partners are looking for, if they really want to enter the Chinese financial market. But a closer look at the outcomes of the negotiating process is needed to determine how satisfactory the partnerships really are. In evaluating the information currently available about those outcomes, three general findings emerge. First, the data support the view that most local banks that take on foreign partnerships improve their capacity for financial innovation -- in organizational structure as well as in products and services provided -- because of the transfer of management knowledge from their foreign partners (the "direct effect"). Secondly, the impact from this "primary" transfer of knowledge can be heightened by an "indirect effect" or "demonstration effect," as competitor banks seek to emulate the improved management style and strategy of the sample banks. Thirdly, in several cases, the early stages of the partnership are marked by conflicts arising from a clash of corporate cultures or other sources; the synergistic benefits looked for in the partnership are delayed, if not entirely absent.

The Shanghai Pudong Development Bank (SPDB) provides a typical example of a successful strategic investment. It had only a 10-year history when Citibank purchased its five percent share in 2003, after which Citibank sent a high level manager to participate in SPDB's decision making. Citibank's expertise in personal financing enabled SPDB to strengthen its competitive capability in this market segment. Citibank also helped to reform SPDB's organizational structure by implementing a matrix form

of management across the head office and branches, which created incentives for product and service innovation at all levels. Citibank's transfer of its skills in credit card operations enabled SPDB successfully to issue the first local currency credit card in China's domestic market. Finally, SPDB progressed in a host of areas through Citibank's guidance in personal finance, risk control, financial management, IT systems, auditing, compliance management and human resource management.

China Merchant Bank (CMB), one of the shareholding banks with no foreign strategic investment to date, might be a beneficiary from an "indirect effect." Its performance is as good, or even better in some dimensions, than that of some shareholding banks that have attracted foreign strategic investors. Home-grown remedies also can improve banks' corporate governance and risk management, as long as the reforming banks adopt the best practices of international finance. The CMB implements a strategy based on "technological innovation" and its operating philosophy is attuned to developments in the market and to catering to customers' demands first. It is recognized widely as one of the best performing banks in China in recent years.

Some cases exhibit the culture shock and rigid adherence to past practices that impede the transfer of management knowledge when foreign investors buy shares in local banks. The positive changes observed in some sample banks' management practices are outcomes of lengthy periods of disputes between partners. In one such instance, Newbridge Capital's investment in the Shenzhen Development Bank (SDB) in 2004 met fierce opposition from local employees because of the difficulties they encountered in changing ingrained work habits. After some time, however, greater harmony developed with the fruitful result that Newbridge enabled SDB, in 2006, to become the first Chinese bank to introduce "supply chain financing."

Shareholding banks as a group still depend very heavily on interest income, and have common shortcomings in their risk management systems. With the increase in domestic and international financial competition, these banks need urgently to enhance both their management capacity and their business strategy. Although the degree of risk in the portfolios of some of these banks might be hidden in the short run by the rapid growth of the national economy and the associated spread of economic prosperity, they could all face serious potential problems in a less benign financial environment. This survey of shareholding banks reveals considerable differences in the quality of their governance and their disclosure of information.

City Commercial Banks

City commercial banks are also shareholding banks, but they are smaller in size and usually regional in focus. Through June 2006, there were 117 city commercial banks (CCBs) in China, 23 of them with RMB 20 billion yuan or more in assets, including the Beijing bank and the Shanghai bank, which are almost comparable to national shareholding banks in the size of assets (more than RMB 200 billion yuan); 26 with assets in the range RMB 10-20 billion yuan; and the remaining 69 smallest banks, with assets below RMB 10 billion yuan.

By the end of 2006, eight of the city commercial banks had selected foreign partners, which had invested RMB 4.6 billion yuan in those CCBs. Foreign investors tend to favor banks in the most developed cities, which tend to offer more attractive financial environments along with higher credit standing. Shanghai Bank, for example, has been demonstrating greater financial strength than any other Chinese CCB, with an excellent financial reporting record since its inception in 1995. Hangzhou Bank attracted foreign investment, even without an international auditor's evaluation of its assets, because of the investor's high degree of confidence in the financial infrastructure of Hangzhou city and the expectation of substantial financial rewards. Some other banks have been less fortunate. After a short honeymoon, the Xian Bank quickly divorced its foreign partners because of management conflicts.

As already noted, there is big difference between the Bank of Shanghai and the others in total assets, deposits and loans. But Nanjing is catching up in the average return on total assets (ROA) and return on equity (ROE). Beijing Bank and Hangzhou Bank both display some evidence of good performance, but, unfortunately, there are insufficient data to confirm the overall quality of their outcomes due to the inadequate information disclosure requirements; the same is true for the other banks. Nonetheless, the partial evidence that is available indicates that city banks in China present attractive opportunities to foreign investors, largely based on the affordability of a meaningful ownership share and the potential for a greater voice in the management and control of operations than would be the case in the large SCBs. Also the Chinese city banks have other advantages compared to larger financial institutions: they are local banks with diversified capital and ownership structures that are close to the communities and customers they serve, with a network of branches and sub-branches spread around the centers of cities, which makes for convenience in the business of retail banking.

Moreover, these small city banks have maintained close relations with local small- and medium-size enterprises during the long economic development history since 1978. These are the enterprises that have been and are likely to continue to be the most dynamic sources of growth in their local communities. As one of the principal pillars of Chinese future economic growth, they are destined to become the most

important customers of the city banks. Since 1996, private enterprises in China -- mostly of small and medium size -- have grown much faster than GDP and now account for more than half of all output and much of net new job creation. These firms produce some 52 percent of GDP but account for only 27 percent of outstanding loans (McKinsey report 2006). Further reform of the banking system will enable banks to channel a larger share of their lending to more productive private enterprises – currently, the main engine of China’s growth – and thereby raise the average productivity in the economy greatly. This highly prospective potential client base will provide a wealth of opportunities for city banks, as well as for the foreign strategic investors who are seeking reliable partners among smaller Chinese banks. Foreign banking expertise promises to be of great assistance to local banks seeking to redefine their positions relative to the market, to improve their governance and risk management, and to develop a capacity for financial innovation in the products and services they supply to enterprises and other clients within their communities -- in summary, to enhance their overall capacity to compete.

For many banks, changes to their operating strategies will be an integral component of their banking transformation, with a predictable increase in the income to be derived from retail services and off-balance sheet activities. With support from government policies that foster the increasing commercialization of banking in China and sustained improvements to the financial regulatory environment, foreign partners can contribute much to the ability of local regional banks to compete effectively. One important caveat, however: because of the continuing underdevelopment of the capital market, most financial risk remains concentrated in the banking system, a situation that is exacerbated by the weaknesses that remain in the supporting infrastructure, especially the legal system, and the tendency to use bank credit to finance what are essentially non-commercial activities. In good times, the banks can carry this burden at a cost, but economic downturns threaten to put them in jeopardy.

The benefits for the foreign strategic investors might be more problematic. Some of their investment partners are not in the best of shape, and the limited investment in stock they acquired might give them little real voice in the way that their local partner is managed. Yet, even with the considerable uncertainty about Chinese banks’ performance, acquiring an equity share in a Chinese bank might prove an effective shortcut to accessing the Chinese market when compared with the alternative of setting up subsidiaries or branches. Some investors might view their strategic investment as a first step towards expanding their presence in China’s financial market.

Events to date have indicated that not all such marriages will be successful. In some instances, the response to the opportunities afforded by strategic investment was limited and late. This might have been

due to inertia and slow decision-making processes by some local partners, as well as to management conflicts between foreign investors and some partner shareholding and city commercial banks. An important finding is that effective cooperation in management between the foreign strategic investor and higher level managers of the local partner bank is a core factor for success of the partnership. Simply investing new capital and introducing new financial products will not payoff unless management has the capacity properly to deploy these resources.

5. Empirical assessing the impact of foreign direct investment in China's banks

This section employs Data Envelopment Analysis to assess the impact of foreign investment in China's banks in order to seek empirical support for the hypothesis that foreign investment has positive impact in China's banks⁹.

a. Methodology

Data Envelopment Analysis (DEA) is an analytical tool that has been extensively used by economists to provide a total performance metric for firms, including banks. It first requires the specification and collection of data relating to outputs and inputs (costs) for a sample of firms. It then uses linear programming to generate a frontier of "best practice" from amongst this group. Where a particular firm lies relative to this frontier then determines its own efficiency score. A firm that lies on the frontier is deemed to be fully efficient and will receive an efficiency score of one. If input prices are also specified, DEA can produce scores relating to technical efficiency (TE), allocative efficiency (AE) and cost efficiency (CE). If a firm receives a technical efficiency score of 0.8, this implies that if it became fully efficient in a technical sense, it could reduce its inputs by 20% and maintain the same level of output. If a firm receives an allocative efficiency score of 0.8, this implies that it could reduce its input costs by 20% through changing its input mix from that which it is currently using to the optimal mix. If a firm receives a cost efficiency score of 0.8, this implies that it could reduce its input costs by 20% if it were to become both technically and allocatively efficient. As DEA is no longer a new analytical technique, it is not discussed here in further detail. However, the interested reader could consult O'Donnell and van der Westhuizen (2002) for an excellent overview of DEA in a banking context.

Two other relevant studies that make use of DEA include Grigorian and Manole (2006) and Chen, et al. (2005). Grigorian and Manole (2006) use DEA to analyze bank performance in the Central and

⁹ A more recent DEA and Tobit regression analysis of the impact of foreign investment in China's banks will appear as Laurenceson and Qin (forthcoming).

Eastern European transitional economies over the period 1995-1998. DEA is used to generate measures of bank performance (efficiency) and a regression analysis is subsequently conducted that seeks to explain the variation in efficiency estimates, including a variable that aims to capture the impact that foreign ownership might have. They report that foreign ownership enhances bank efficiency only when it conveys controlling power. Chen, et al (2005) examined the performance of 43 Chinese banks during 1993-2000, which coincided with a period of domestic financial liberalization. They reported that larger state-owned banks and smaller banks were more efficient than medium-sized ones. Financial deregulation in the mid-1990s also appeared to improve cost efficiency levels amongst banks generally.

As this study has access to the same basic data as that of Chen, et al. (2005), albeit more recent, it largely follows their approach in defining inputs, outputs and input prices. Outputs are specified to include loans, deposits and non-interest income. While loans and non-interest income from non-loan assets are relatively straightforward, the treatment of deposits is less so. On the one hand, deposits might be considered an input in producing loans and other assets, not as an output in itself. On the other hand, as Chen, et al. (2005) discuss, deposits also provide liquidity, safekeeping and payments services to depositors. Cavallo and Rossi (2001) suggest resolving this issue by taking a dual approach in which the volume of deposits is considered an output, while the cost of deposits is considered an input cost and the interest rate paid on deposits is the input price. Aside from interest expenses (i.e., the cost of deposits), non-interest expenses are included as another input cost. The price of deposits is calculated as interest expenses divided by deposits and the price of non-interest expenses is calculated as non-interest expenses divided by assets. The latter approach to specifying input cost and price is admittedly less than ideal as it encompasses several inputs including capital and labor. Ideally, one would have cost and price data available for a more disaggregated collection of inputs (e.g., O'Donnell and van der Westhuizen, 2002), but unfortunately these data are unavailable for Chinese banks. Accordingly, when DEA generates measures relating to TE, AE and CE, we put more emphasis on TE given that it is independent of input price data.

All data were obtained from the *Bankscope* database and cover the period 2001-2006. Unlike Chen, et al. (2005), this study excludes data relating to trust and investment companies because these financial institutions differ considerably from commercial banks in nature (Kumar, et al., 1997). As DEA determines a particular firm's performance by referencing it to the performance of other firms included in the analysis, the inclusion of data relating to trust and investment companies might introduce an unwanted bias into the results. Thus, our sample includes the big four ex-state-owned banks, national and regional

joint-stock commercial banks and city commercial banks. The smallest number of available observations is 21 for 2001 and the largest is 49 for 2005.

The study first calculated efficiency scores for all banks and then grouped the scores according to whether the bank had or did not have foreign investment in a given year. A test was then performed to see if there was a significant difference in the mean performance of the two groups. Assuming that the causality runs from foreign investment to bank performance, if foreign investment did convey a special performance impact, the group that has taken on foreign investment should have performed relatively better. Moreover, the expectation is this difference in performance would have grown over time as, for the group as a whole, foreign investors continued to transfer technology and/or the technology that was previously transferred permeated to a greater extent the operations of the Chinese banks. If the mean performance of the two groups was indistinguishable, this would be evidence that the minority stakes that foreigners have been permitted to acquire have given them insufficient incentive and/or ability to transfer technology.

Clearly, foreign investors may tend to invest in banks of a certain performance level, most likely, the better-performing banks. Thus, superior performance by banks with foreign investment should not automatically be taken as evidence that foreign investment has had a positive impact. Of course, the above proposition is not a general one. One might also speculate that some foreign banks would prefer to invest in poorly performing banks because they can acquire a stake in these banks more cheaply and they offer a greater “upside”. For example, in 2005 and 2006 two foreign-led consortiums aggressively bid to take a stake in the Guangdong Development Bank, a highly distressed domestic lender. Therefore, after conducting the comparative group analysis, the study also provides performance estimates for individual banks over time -- both prior to and after taking on foreign investment. In this analysis, the performance of the bank that had attracted foreign investment is referenced against all other banks (for which data were available) that had no such investment. Another reason to consider efficiency scores for individual banks over time is that it may help to assess whether those banks that have sold larger equity stakes to foreigners have experienced greater performance dividends.

b. Results and analysis

Table 6 shows the mean efficiency scores for the group of banks that had foreign investment and for the group that did not. Several points are noteworthy. First, while banks with foreign investment

Table 6 Efficiency scores for banks with / without foreign investment

	Banks without foreign investment	Banks with foreign investment
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Year	TE	AE	CE	Average	TE	AE	CE	Average
2001	0.91	0.93	0.84	0.89	1	1	1	1
2002	0.93	0.91	0.84	0.89	1*	0.99*	0.99*	0.99
2003	0.91	0.92	0.83	0.89	0.93	0.83	0.78	0.85
2004	0.81	0.85	0.69	0.78	0.83	0.94*	0.78	0.85
2005	0.86	0.87	0.74	0.82	0.91	0.92	0.84	0.89
2006	0.90	0.95	0.85	0.90	0.96	0.99	0.95*	0.97

Notes: * indicates a statistically significant difference in means at the 5% level. The number of banks without/with foreign investment was: 2001 – 20/1; 2002 – 27/2; 2003 – 36/3; 2004 – 39/9; 2005 – 36/13; 2006 – 12/14 (only partial data available).

typically had higher efficiency scores than those without, this difference was rarely statistically significant. This holds true even in the later years during which any performance payoff from foreign investment should have been more discernable. These findings suggest that the equity stakes that foreign investors have been permitted to acquire have been insufficient to provide them with the incentive and/or ability to transfer advanced technology, at least when banks with foreign investment are taken as a group.

Secondly, not only is the efficiency of banks without foreign investment typically not significantly lower than those that have, their efficiency scores are quite high in an absolute sense. For example, in 2006, the latest year covered in the analysis, the TE score for banks without foreign investment indicates that, as a group, they would only need to cut input costs by 10 percent to reach the best practice frontier. Indeed, several banks amongst this group helped to form the frontier. Similarly, their AE score indicates that adjusting their input mix to the optimal mix would yield cost savings of only around 5 percent. These results suggest that some of the dire predictions regarding the ability of domestic banks to compete in the post-WTO environment were exaggerated. In particular, they suggest that banks without foreign investment might be able to acquire technology and improve their efficiency through other means. Of course, foreigners could have played a role in this process, even if not through the purchase of equity. For example, wholly foreign-owned banks in China might have contributed through “demonstration effects,” or Chinese banks might have hired staff with experience working in foreign banks. The fact that China can count amongst its territories a world-class international financial centre in Hong Kong, SAR, is also likely to have provided a tremendous boost to all banks on the mainland, irrespective of whether they have sought foreign investment.

Table 7 shows the efficiency scores for individual banks that took on foreign investment between 2001 and 2006. These results show that most of the Chinese banks in which foreigners have acquired

Table 7 Efficiency for individual banks with foreign investment

Bank (year of foreign investment)	2001		2002		2003		2004		2005		2006	
	TE	Ave										
Bank of Shanghai (2001)	1	1	1	0.98	0.96	0.83	1	0.94	1	1	1	1
Bank of Nanjing (2002)	1	1	1	1	0.83	0.71	0.57	0.69	0.86	0.83	0.99	0.99
Shanghai Pudong Development Bank (2003)	0.86	0.81	1	1	1	1	1	1	1	1	1	1
Bank of Communications (2004)			1	0.97	0.99	0.91	0.98	0.81	1	0.99	1	1
China Minsheng Bank (2004)	1	0.95	1	1	1	1	1	0.99	1	1	0.96	0.98
Industrial Bank (2004)	1	1	1	0.97	1	1	1	1	1	1	1	1
Jinan City Commercial Bank (2004)	0.96	0.97	1	0.96	0.88	0.92	0.87	0.87	1	0.93	1	0.98
Shenzhen Development Bank (2004)	1	0.81	0.95	0.95	0.94	0.90	0.72	0.81	0.93	0.91	0.91	0.94
Xian City Commercial Bank (2004)	0.53	0.68	0.59	0.70	0.65	0.74	0.45	0.62	0.65	0.74		
Bank of Beijing (2005)	1	1	1	1	1	1	1	1	1	1		
Bank of China (2005)					1	1	1	1	1	1	1	1
China Construction Bank (2005)			1	1	0.96	0.90	0.96	0.86	1	0.99	1	1
Hangzhou City Commercial Bank (2005)	1	1	0.99	0.88	0.92	0.76	0.61	0.57	0.78	0.71	0.87	0.88
Industrial and Commercial Bank of China (2006)					1	1	1	1	1	1	1	1
Huaxia Bank (2006)	0.98	0.87	0.88	0.85	0.96	0.92	0.93	0.95	1	1	1	1

Notes - A blank space indicates that a datum was unavailable for the year.

equity were already comparatively efficient beforehand. For example, excluding the Bank of Shanghai, which accepted foreign investment in 2001 and for which earlier data are unavailable, nine of the other 14 banks had TE scores of 0.99 or above in the year prior to taking on foreign investment. This largely makes moot the possibility raised earlier that those banks that sold a larger equity stake to foreigners might have experienced a larger performance improvement. To say that most of the banks in Table 6 were already comparatively efficient prior to receiving foreign investment is, of course, not to say that they were efficient in the sense of reaching international best practice. Rather, simply put, they were efficient compared with the other Chinese banks that contributed to the DEA analysis, i.e., those Chinese banks that had not received foreign investment. Another interesting point to note is that no bank in Table 6 exhibited a clear improvement in efficiency after partnering with a foreign investor. For example, after receiving an average efficiency score of 1 in 2001, the Bank of Nanjing's performance since receiving foreign investment in 2002 has been mixed. The Xian City Commercial Bank showed signs of inefficiency prior to seeking foreign investment in 2004; in 2005, there was no obvious improvement.

The key finding of this empirical assessment is that the Chinese CCBs with foreign investment do not appear to have become significantly more efficient than those that have none. Moreover, when

considering the performance of individual banks over time, none shows an obvious improvement in efficiency after taking on a foreign partner compared to those that have not. One caveat to this conclusion is that the period covered by the analysis may have been too short for the full benefits from foreign investment to be realized. For example, there can be little doubt that the success of the IPOs conducted by CCB, BOC and ICBC in 2005 and 2006 was in large part attributable to the presence of their strategic foreign investors. The benefits associated with their raising of new capital, however, may not be realized fully for several years into the future. Nonetheless, the general thrust of the findings for policy is clear: the approach of Chinese Government to date in only permitting foreign investors to take minority stakes in Chinese banks appears sub-optimal as far as the efficiency performance of these banks is concerned. One should note, as well, that the equity shares actually approved for sale to foreigners in most cases have been considerably lower than the upper (regulatory) limit of 25 per cent.

This conclusion is consistent with the findings of Grigorian and Manole (2006) noted earlier, which were that banks in other transitional economies only experienced performance improvements in instances where foreigners had been permitted to acquire a controlling stake. The conclusion is not surprising also in light of the fact that, according to Table 4, in many cases foreign investors hold no more than 10 percent of the equity in the banks in which they have invested. According to the definition used by the likes of the OECD, such investment could be considered portfolio rather than direct investment because owners having less than a 10 per cent equity stake are presumed to be unable materially to influence or participate in the management of the firm. Another pertinent issue is that a 10 percent holding might convey controlling power if it was comparable to the stakes held by other leading shareholders. But in China that is not so, in most cases. Particularly in the large banks, the Chinese Government remains the sole dominant shareholder; e.g., the Chinese Government holds a 60 percent equity share in ICBC compared with the 8.5 percent combined share held by three foreign strategic investors.

6. Concluding remarks and policy implications

This study traces the patterns of foreign banks' direct investment in China since 1978 when the open door policy began. On a broad level, the comparative analysis and empirical assessment conducted herein are concerned with one fundamental question: does direct investment by foreign banks impact China's banking industry positively, and, if so, how?

Summary of Findings

A longitudinal analysis revealed that foreign financial institutions changed their prevailing mode of direct investment in China as a response to changes in regulations. Initially, foreign banks entering China did so by establishing branches and/or representative offices typically in the main domestic financial centers. Many of these foreign bank entrants followed their own domestic customers who were establishing direct investment ventures in China, especially in the Special Economic Zones located around more developed and/or coastal provinces and cities. These favored locations featured comparatively well-developed software and hardware environments, including accommodating regulatory regimes, which encouraged keener competition between foreign and domestic banks. This competition involved not only on-balance sheet activities but also such off-balance sheet activities as settlement agency and personal financial assets management. Foreign banks tended to equip themselves with much better customer information through professional database management than did local banks. That helped the foreigners to gain better access to VIP customers, whether foreign or local enterprises, whether wholesale or retail clients, whether individuals or firms. The presence of foreign bank stimulated a more competitive environment in China's banking sector, in turn encouraging local banks to respond through financial innovation.

Strategic foreign investment through buying shares in Chinese banks has become a more recent alternative way to gain entrance to China's financial market that has appealed both to domestic and foreign banks as the realities of competition on the terms determined by accession to the WTO became apparent. Already, foreign strategic investors have played an important role when the SCBs started their IPO processes abroad. Reputable foreign investment in the major SCBs lent credibility to their disclosure statements and created expectations for beneficial changes in their governance arrangements, management processes, internal auditing, and risk assessment techniques. As well, as foreign investors engaged with several Chinese partner banks, their presence pointed to the onset of fundamental changes in China's banking system that would contribute to a more efficient, competitive financial system overall. System-wide improvements can be thought of as "external effects" of foreign engagement, compared with the beneficial "internal effects," e.g. higher operating incomes and lower operating costs.

The benefits for the foreign strategic investors might be more problematic. Some of their investment partners are not in the best of shape, and the limited investment in stock they acquired might give them little real voice in the way that their local partner is managed. Yet, even with the considerable uncertainty about Chinese banks' performance, acquiring an equity share in a Chinese bank might prove an effective shortcut to accessing the Chinese market when compared with the alternative of setting up

subsidiaries or branches. Some investors might view their strategic investment as a first step towards expanding their presence in China's financial market.

The key empirical finding is that the Chinese banks that have received foreign investment do not appear to have emerged as being significantly more efficient than those that have not. Moreover, when considering the performance of individual banks over time, none show an obvious improvement in efficiency after foreign investment compared to those that have not. One caveat about this conclusion is that the period considered by the analysis might have been too short for the full benefits from foreign investment to be realized.

Events to date have indicated that not all such partnerships have been successful. In some instances, the response to the opportunities afforded by strategic investment was limited and late. This might have been due to inertia and slow decision-making processes by some local partners, as well as to management conflicts between foreign investors and some partner shareholding and city commercial banks. An important finding is that effective cooperation in management between the foreign strategic investor and higher level managers of the local partner bank is a core factor for success of the partnership. Simply investing new capital and introducing new financial products will not pay off unless management has the capacity properly to exploit new opportunities.

Moreover, the study found evidence that some shareholding banks perform better than others without support from foreign strategic investment. The survey of Chinese shareholding banks displays big differences in their arrangements for governance and information disclosure; they also differ from each other in their capacity to cope with economic volatility and their ability to resort to their shareholders in the event of financial need.

There seems to be great potential for foreign banks to invest in China's city commercial banks. Most of these small- and medium-sized banks are at an early stage in their development, and some of them, encouraged by the government, are seeking suitable foreign strategic investment. Of course, this is not to suggest that the introduction of foreign investors can resolve all the problems of China's banks or of the domestic banking sector in general; rather, foreign investment is viewed as a stimulus to more effective competition throughout the whole domestic banking industry. From 2007, all banks operating in China face the same domestic and international financial environment, and compete on the same level playing field.

Implications for the banking sector and government policy

The introduction of foreign investors is one of the possible ways for China effectively to restructure the banking sector; foreign strategic investment promises to be beneficial in most cases for both the big SCBs and the smaller shareholding and city commercial banks. But there are alternative ways to attain excellent bank performance through improved corporate governance and better management of risk, so long as banks are prepared to adopt the standards and adhere to the best practices of successful international financial institutions.

Most of China's shareholding banks still depend too much on interest income, and many of them have shortcomings in the way in which they manage their risks. To compete effectively with a growing number of domestic and international financial institutions, these banks need urgently to enhance the strategic capability of their executives. The underlying riskiness of the business models of many of China's banks might be hard to recognize in the short run because the exceptional growth performance of the Chinese economy enables even poorly managed banks to maintain the appearance of prosperity.

One of the shortcomings of the Chinese banking sector is the tendency for all banks, irrespective of their size, location and other characteristics, to target the same business lines and client groups; a herd mentality tend to rule. In consequence, there is a bias towards over-supply of services of the same kind to the same mass of customers; the resulting excessive competition compresses margins and the profitability of the banks' activities. Moreover -- the other side of the coin -- there are many financial products and services that are under-supplied, in the sense that the competition to meet the demands of clients is less than needed to ensure those demands are met at a reasonable cost. Many banks would serve their customers better by identifying business lines in which to specialize, or by implementing a diversified strategy that enables them to focus on banking activities that best utilize their current (or prospective) competitive advantages.

The study findings suggest, furthermore, that the Chinese government has a simple way to select those multinational banks that it seeks as investors without violating WTO rules. As the size of a bank matters in the FDI decision, the government can reduce the effort it must devote to review and evaluation by specifying a minimum size for acceptance of applicant foreign banks as well as for their investment.

The WTO entry in 2001 heralded a new stage of financial reform in China. The commitments China made constituted an important step toward transforming the financial sector into one that is internationally competitive. Nonetheless, the commitments made are equally notable for their limitations. If Chinese banks are to realize the full benefits that might be associated with foreign investment, foreign investors will need to be permitted to take equity stakes that provide them with the incentive and ability to

transfer their best technology and to exercise a controlling influence on the banks into which they invest. To not do so will slow the growth in efficiency of Chinese banks, as well as the efficiency with which capital is allocated in the economy as a whole.

Currently, the trend, worldwide, is for the banking industry to remove the firewalls between commercial banking and investment banking activities, and to approve, and even encourage, financial institutions, including bank shareholding companies, to offer universal banking services. The main concern with financial institutions that endeavor to supply all kinds of financial products and services relates to their ability to manage the risks that accompany the integration of different activities. In China, as financial institutions enter the world of universal banking, there will need to be a careful re-thinking of the appropriate supervisory regime; how the three independent regulators (or, possibly, a new single regulator) supervise(s) “banks” as integrated corporations that supply services involving banking, insurance and securities (underwriting, trading, wealth management, and so forth) remains to be determined.

Remaining questions

One of the big remaining problems for analysts of the Chinese banking system is the inadequacies of the data available on banking activity. In part, this results from deficiencies in the requirements for disclosure of information, and in part it reflects the lack of regular financial reports from shareholding bank and (most) city commercial banks at what is the beginning of the era of greater transparency. Problems exist also with the quality of information reported, e.g. information on the assets of the Agricultural Bank of China, the Everbright Bank and many other city commercial banks. For these banks, one cannot make conclusions about the improvements, if any, in profitability due to strategic investment.

Good financial performance after foreign investment might signal only that foreigners have invested in better-performing banks; a bank with foreign investment may be performing better than average after the event, but possibly the bank was always performing better than the average of its competitors. Targeting on shareholding banks or city commercial banks probably would be more informative at this stage because there are many of these banks, so even if some have foreign investment others do not. This means that one can compare those with and without foreign investment more easily. For example, comparing the performance of ICBC, CCB and BOC with the “average” makes little sense because ABC is the only big state bank without foreign investment.

Beyond this limitation, there are other issues concerning foreign strategic investment in China’s banking industry. First, people argue that, even if foreign strategic investment potentially could enhance

the management effectiveness of a domestic bank, meaning in some cases that strategic investors have agreed to provide training in management techniques, in practice, training often focuses only on general operating measures, and neglects core or principal management methods.

Another criticism of strategic investment is that, after reform of the shareholding system and external IPOs, the organizational structures of the banks tended to change much more than their cultures. The revised structure of banks with strategic FDI tends to conform to the organizational style of the foreign bank partner, but operations tend to be conducted in the same mode as before. An implication is that the limited equity control acquired by foreign investors might provide them with insufficient incentive to expend substantial effort to improve the local bank's management and efficiency. The foreign investors might be satisfied with using the branch network and customer relations of their local partners to market their own products. When all is said and done, more work is needed in China to provide the right financial environment for a modern banking sector. Even as some banks make considerable efforts to modernize their banking operations, to complete IPOs, and/or to introduce strategic investors, they need to recognize that those efforts will bear considerable fruit only if they succeed as well in introducing revolutionary changes in their internal banking cultures.

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