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China's financial markets – a future global force?

As the world struggles with the financial crisis and its repercussions on the global economy, questions inevitably arise as to what and who will drive the financial markets in future years. China is likely to be one of the key players, given its dynamic development.

China's financial markets have enjoyed a period of strong growth since the early 1990s, even though they are still relatively small compared to those of industrial countries and some other emerging markets.

Regulatory bodies have followed a careful and gradual reform path and will most probably continue with this approach. Given the current turmoil in global financial markets and the experience of successful gradual reforms, this approach is likely to provide a good basis for sustainable development in the future.

It would be unrealistic to expect China to emerge unscathed from the global recession. The weaknesses of less financially sound banks will be exposed during the downturn. A strengthening of provisioning and the capital base will be needed in light of a potential rise in credit losses.

Risk management is a crucial determinant of winners and losers. It is important that Chinese banks continue to strive for prudent risk management.

In ten years, China is likely to account for 13% of the banking market, over 16% of the stock market and over 5% of the bond market worldwide. Even under conservative assumptions, China's share in global financial markets is set to grow.

China's future role in global finance depends on its ability to open up. Granting greater market access to foreign financials will be a vital prerequisite for sustained development, and greater integration and regulatory convergence efforts especially with the US and the EU should be key policy objectives.

The "going global" drive of Chinese financial institutions marks a second wave of Chinese outward investments. While the increasing internationalisation of Chinese financial institutions is not a totally new phenolmenon activity has increased markedly since 2006. In the near term, Chinese banks' earnings and profit outlook for 2009 to 2010 as well as regulatory considerations are likely to curb their global expansion. Over the medium and longer term much will depend on how the global economic system evolves from the crisis.

The Chinese state is a global investor set to grow further. In recent multilateral initiatives, China has contributed to the acceptability of sovereign investments. While advanced economies need to maintain liberal investment conditions, China is still at a starting point of opening up to foreign investments.

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Editorial

The financial crisis has thrown the banking world into turmoil. As the dust settles, questions inevitably arise as to what and who will drive the financial markets in future years. China has on many occasions been identified as one of the potential key players, given its size and share in the global economy and its vigorous pursuit of economic reform for several decades. Whether the country will be in a position to meet these expectations critically depends on how deeply it will be affected by the current crisis, how well it can emerge from the turmoil, and how its markets and regulators respond to the recent experiences. We set out to explore these questions, and assess China's prospect in a series of chapters in this report.

We start by looking at the existing structure and recent developments of China's own domestic financial markets, assessing its capability and potential. We then take a critical look at the state of China's banking sector and how it will be impacted by the current global financial crisis. The potential of China's domestic banking sector is also examined. We try to gauge the current extent of China's integration into the global financial markets. The opening of China's markets to outside investors and the progress and prospects of regulatory liberalisation are also scrutinised. Finally, we look at China's own reach around the world through different angles: China's financial institutions going abroad and China's role as a global investor.

China's financial markets will continue to evolve as guided by its domestic dynamics and needs as well as external opportunities and circumstances. It is clear that China has global ambitions on top of the potential to be a key player in the world financial markets, and the country has made great strides in recent years. The journey is still in its early stages, and there will be many pitfalls ahead. As China continues to rise, it is difficult to imagine that its level of engagement or influence on the world stage will not grow.

Syetarn Hansakul *Steffen Dyck* *Steffen Kern*

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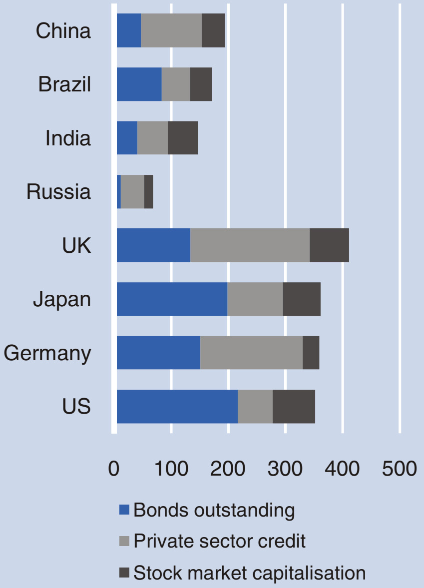
China's capital markets – structure and market development

The development of China's capital markets can be divided into three phases[1]. Between early 1978 and 1992 full-scale economic reform took place, with capital markets emerging in response to the beginning incorporation process of Chinese enterprises as the concept of privatisation took off following the introduction of the Open Door policy. In the second phase (1993-1998), the focus shifted to strengthening the capital markets in terms of institutional framework as well as supervisory framework. Supervision of capital markets was consolidated, leading to the formation of the China Securities Regulatory Commission (CSRC) in its current form. Regional pilot programmes were expanded nationwide. The promulgation of the Securities Law marked a milestone in the third phase between 1999 and 2007, resulting in formalisation and strengthening of the legal status of China's capital markets. The emphasis rested on refinement of the legal and regulatory system to create a more transparent and efficient market. Concepts such as corporate governance and market discipline were introduced. Further, a series of reforms were implemented to facilitate future development of national capital markets in terms of product diversification.

While substantial progress has been made and reforms are generally heading in the right direction, several areas are still subject to further work. These include, among others, corporate governance as well as capital market infrastructure and rating agencies. In order to make China's financial markets really world-class they have to become freer, more transparent and better regulated. Aside from increasing the share of institutional investors, especially in the stock market, it is necessary to raise the general level of financial literacy. By successfully implementing these reforms, China's financial markets will be in better shape to serve investors' and fund raisers' needs at the same time, and thus support China's long-term growth in a more efficient manner.

Financial markets in comparison

% of GDP*, 2008 (latest available data)

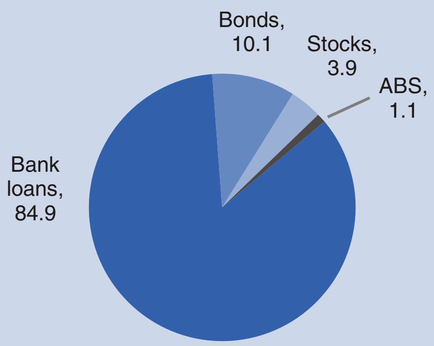


*As shares of 2008 est. GDP

Sources: BIS, Bloomberg, IMF IFS, DB Research 1

Non-FIs rely heavily on banks

% of total external financing, 2006



Source: CSRC 2

Structure of China's capital markets

Compared to industrial countries, China's financial markets are still relatively shallow as measured in relation to nominal GDP (see chart 1). Bank loans to the private sector account for the lion's share – not least due to the recent steep decline in the stock market. However, in a BRIC comparison, China leads in terms of combined financial market depth.

The comparatively large share of private sector credit shows that the Chinese economy remains heavily dependent on bank finance. Bank loans account for more than 80% of total financing to the non-financial sector, while equity and bond issuance plays a subordinated role (see chart 2). Aside from financial risk concentration in the banking system[2] this signals that capital markets are still underdeveloped.

[1] See CSRC (2008). China Capital Markets Development Report. China Securities Regulatory Commission. March 2008.

[2] People's Bank of China (2008a). Financial Stability Report 2007. March 2008, p. 28.

Brief history of China's bond market

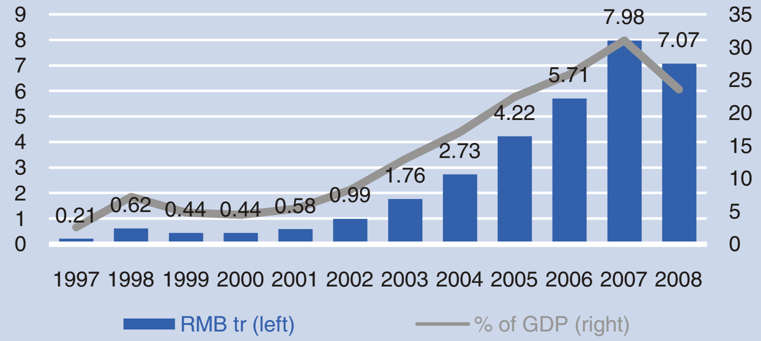
While some kind of financing instruments resembling bonds can be traced back to China's "Spring & Autumn" and "Warring States" periods (770 B.C to 256 B.C.), bonds in a modern sense became more widely used during the late 19th / early 20th century to finance government spending and large infrastructure projects. Having vanished following the foundation of the PRC in 1949, the bond market came back to life in the early 1980s as economic reforms kicked off and enterprises had to diversify their funding sources. Treasury bonds were relaunched in July 1981 and, from 1982 onwards, corporate bonds re-emerged. A wave of corporate defaults started in 1993 leading to a period of decline in corporate issuance. Financial bonds became a regular financing instrument for banks from 1984 on. Starting from April 1988, trading of treasury bonds by retail investors was permitted in seven cities and by the end of that year it had spread across the country. The interbank segment was established by the PBC in 1997 – open only for domestic institutional investors. After 2000, the range of market participants was broadened to also include domestic non-financial institutions. International institutions were also given permission to issue so-called Panda bonds – bonds denominated in RMB. In exchange-based trading, net price bond trading was introduced in 2002 and the following years witnessed a number of new products, including asset-backed securities by non-FIs. OTC trading was also established in 2002 in order to service retail investors and SMEs.

Bond market

Market structure

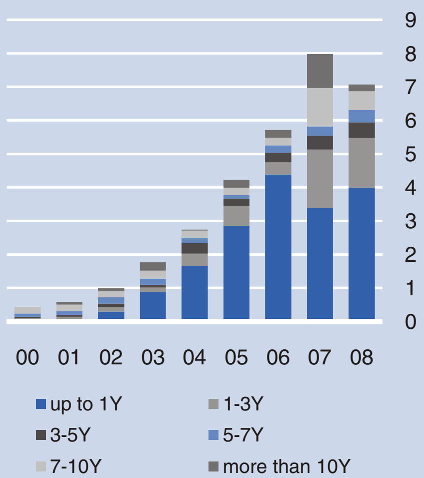
Although total annual issuance has surged since the early 2000s – from less than RMB 1 tr to RMB 8 tr as of end-2007 – China's bond market is still relatively small as a share of nominal GDP (35% in 2007) especially when compared to mature economies. Public sector issuance continues to dominate. People's Bank of China (PBC) and treasury bonds accounted for almost 80% of total issuance in 2007 and more than 75% until September 2008. In the categories "financial bonds" and "corporate bonds", entities that are linked to the state play the most important role. Policy bank[3] bonds constitute more than 90% of total issuance of financial bonds. Accordingly, commercial bank bonds make up only roughly 10% of the total issuance volume. Among corporate bonds, those from state-owned enterprises account for more than 70% of the total until September 2008, almost unchanged from their 2007 share.

Strong growth until 2008
Total annual issuance



Source: Chinabond 3

So far no major shifts in term structure
RMB tr



Source: Chinabond 4

The higher treasury share in 2007 can be attributed to the issuance of so-called "special T-bonds" which were used to buy USD 200 bn in foreign exchange as capital funds of China Investment Company (CIC)[4]. Frequency and issuance volume of PBC bonds also increased again starting in 2007 as the effect of monetary policy tightening. However, due to a policy change towards monetary easing PBC issuance declined in late 2008.

The share of bonds with maturities of less than one year has traditionally been high in China's bond market. It rose from 30% in 2002 to more than 75% in 2006, but in 2007 declined sharply to less than 45%. However, in the same year the share of bonds in the one to three year range rose to 22%, which means that the term structure of the Chinese bond market remains skewed towards the short end. Longer-term issuances could gain some ground in 2007, but issuance data for 2008 suggest that shares of bonds maturing within seven to ten years or after ten years are back to single-digit territory again.

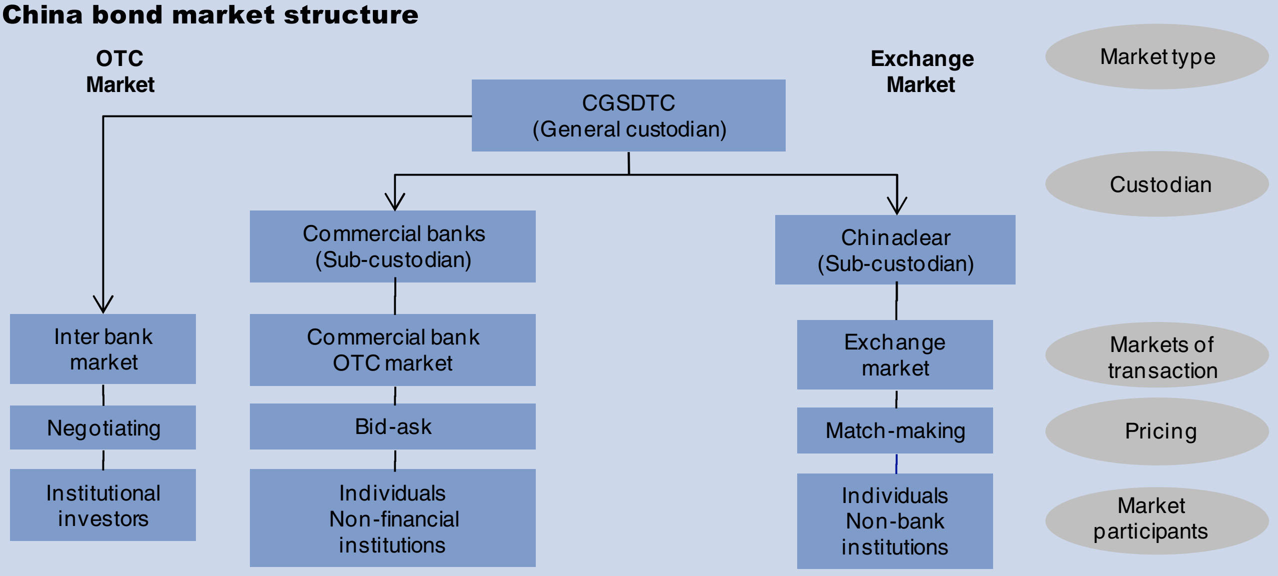
The Chinese bond market can be separated into two sections: the OTC section – which can be sub-divided into an interbank and the commercial banks' OTC market – and so-called exchange-based

[3] Policy banks are: China Development Bank (CDB), Export-Import Bank of China (Eximbank), and Agricultural Development Bank of China (ADBC).

[4] China Government Securities Depository Trust & Clearing Co. Ltd (2008). China Bond Market Review 2007. January 2008, p. 21.

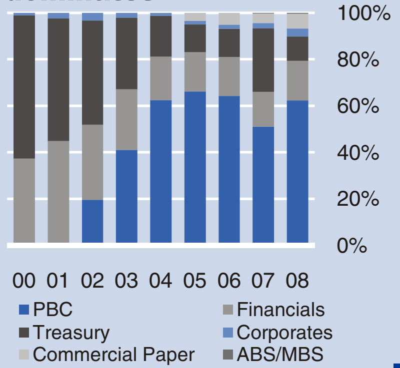
trading (see chart 5 below). The OTC market accounts for more than 97% of total transaction value, with the overwhelming majority in interbank activity and followed by exchange-based trading in Shanghai and Shenzhen (2.7%). The China Government Securities Depository Trust & Clearing Co. Ltd. (CGSDTC) takes the function of centralised depository and settlement for all market segments with commercial banks and Chinaclear[5] acting as sub-custodians in the OTC market and exchange-based trading, respectively.

China bond market structure



Source: Chinabond 5

Public sector issuance dominates



Source: Chinabond 6

Bond holding structure

% of total

	2008	2007	2006
Commercial banks	57.1	59.0	64.6
of which foreign	0.5	0.5	0.4
Credit cooperatives	3.1	2.7	3.6
Securities, funds companies, other non-bank FI	7.5	4.3	8.8
Insurance companies	11.3	9.4	10.3
Exchanges	3.1	3.9	6.2
Others (incl. Special members, non-FI, individuals)	17.8	20.7	6.5

Sources: Chinabond, DB Research 7

Liquidity & trading overview

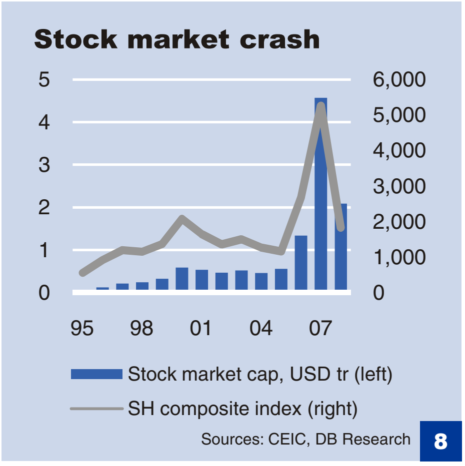
Market liquidity measured by turnover ratios (calculated as trading volume divided by value of outstanding bonds) is higher for corporate bonds than for government bonds, making mainland China an exception in emerging Asia[6]. However, when looking at bid-ask spreads, liquidity seems to be much higher for government (i.e. treasury) bonds. This has probably to do with the dominant position treasury bonds have with regard to issuance and amount outstanding, which also translates into much higher trading volumes for government bonds (approx. eight times the trading volume of corporate bonds).

Market participants

Domestic commercial banks are the major players in China's local bond market, holding close to 60% of the total amount outstanding (see table 7). However, their share has been declining from around 65% in 2006, while the share of insurance companies and other market participants has risen substantially. This trend can be linked to CSRC's explicit policy of broadening the investor base and making the bond market an alternative for institutional investors. Also, demand for life insurance products has likely risen but only at slow pace. Ongoing reform of the social security system coupled

[5] Chinaclear (or China Securities Depository and Clearing Corp. Ltd.), established in 2001, is in charge of clearing any security transaction and also covers the role of custodian for China's stock exchanges, comparable to Germany's Clearstream. Shanghai and Shenzhen stock exchange both hold 50% stakes in the company which is under supervision of CSRC.

[6] ADB (2008). Asia Bond Monitor 2008, November 2008.



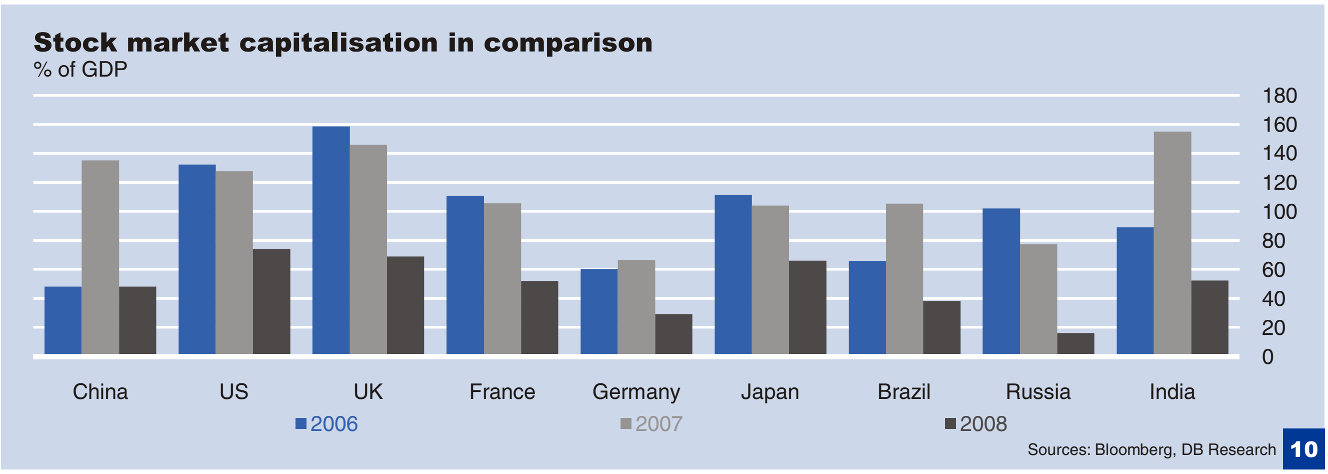
with growing sophistication and awareness on the part of market participants will help to increase the share of institutional investors like insurance companies.

Stock market

China operates two stock exchanges, one located in Shanghai and the other one located in Shenzhen. Instruments traded on both exchanges include shares (A shares and B shares), convertible bonds, warrants, closed-end mutual funds, ETFs, corporate and government bonds, and repos. Aside from B shares, all instruments are only denominated in local currency.

China's stock market experienced a first period of strong growth between the mid- and late 1990s with the Shanghai Composite Index almost quadrupling within five years. However, over the following five years, the index lost half of its value. Starting in 2006, China's stock markets witnessed a stellar rise and the Shanghai Composite Index doubled in both 2006 and 2007 (see chart 8). In 2007, the combined market capitalisation of both exchanges in Shanghai and Shenzhen reached almost 140% of GDP, making China's stock market the second-largest in Asia after Japan's. In a global comparison, China's stock market capitalisation was the third-largest. Average daily trading volume reached USD 26 bn, making it one of the most actively traded[7] markets worldwide. However, after the stock market started to correct in October 2007, market capitalisation declined to around 50% of nominal GDP as of end-2008[8]. Trading activity also dropped, reaching USD 17 bn on a daily average basis.

The strong rise and sharp fall of the Chinese stock market is also reflected in IPO figures. Both the amounts raised as well as the number of IPOs rose sharply between 2005 and 2007. By November 2008, they had fallen below their 2005 levels (see chart 9).



7 World Bank (2008). China Quarterly Update. February 2008, p. 17.
8 See, for instance, Yao, Shujie and Dan Luo (2008). Chinese Stock Market Bubble: Inevitable or Incidental? The University of Nottingham China Policy Institute. Briefing Series No 41, August 2008.

Overview of China's stock exchanges

	Shanghai Stock Exchange		Shenzhen Stock Exchange		Total	
	end-2008	end-2007	end-2008	end-2007	end-2008	end-2007
Companies listed	864	860	740	670	1,604	1,530
Market cap. (RMB bn)	9,725.2	26,983.9	2,411.5	5,730.2	12,136.6	32,714.1
A-shares	9,687.5	26,849.7	2,369.1	5,609.0	12,056.7	32,458.8
B-shares	37.7	134.2	42.3	121.2	80.0	255.3
Avg. daily turnover (RMB bn)	1,572.5	1,973.5	786.3	933.5	2,358.8	2,907.0
A-shares	1,568.0	1,960.8	782.5	925.8	2,350.5	2,886.6
B-shares	4.6	12.7	3.8	7.7	8.4	20.4

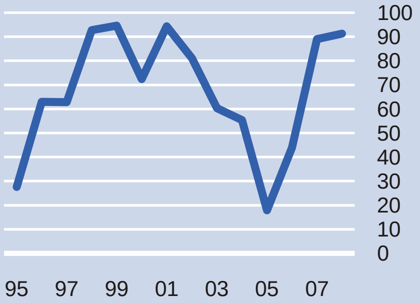
Sources: Shanghai Stock Exchange, Shenzhen Stock Exchange, CEIC **11**

A&B shares

There are different share types in existence, although for China's domestic stock markets so-called A-shares and B-shares are most important (see table 13). Both types are issued by companies incorporated in the People's Republic of China (PRC), the main difference being who is entitled to trade them. Chinese nationals as well as foreign institutional investors authorised under the Qualified Foreign Institutional Investor (QFII) scheme are allowed to buy and sell A-shares that are denominated in RMB. B-shares – which are denominated in USD or HKD – were originally designed for foreign investors only, but since March 2001 domestic retail investors are also allowed to trade them.

Importance of A-shares in raising capital

% of total (incl. H-shares)



Sources: CSRC, CEIC **12**

However, judging from figures regarding total capital raised, A-shares are by far the most important segment in China's stock market (see chart 12) and, since the early 2000s, the amount raised via B-shares has been virtually zero. The drop in the share of capital raised via A-shares in the period 2003-06 can be attributed to the strong growth in capital raised via H-shares issuance.

The little attention paid to the B-shares market over the past decade can be explained by their huge discount compared to A-shares. Also, it seems that the B-shares market has lost its function, since it was originally designed to attract limited foreign investment, which can now also be achieved via QFIIs. Liquidity has been scarce over the past few years, and a possible merger of A and B-shares also adds to subdued performance of the latter. However, still existing restrictions on full convertibility of the RMB pose an obstacle to such a merger.

Derivatives in China's financial markets

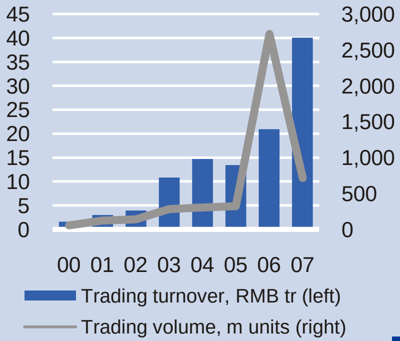
Regarding derivative financial products, the Chinese government has taken a cautious approach towards liberalising derivatives markets. First experiments with futures exchanges date back to the early 1990s, starting with grain forward contracts and metals futures. Treasury bond futures were introduced in December 1992 and both markets experienced chaotic development leading to stronger regulation from the mid-1990s onwards. In general, derivatives have been permitted in selected market segments, primarily commodities. Here, too, a lively market has developed in the past decade, featuring a turnover of more than RMB 40 tr (USD 5.8 tr/EUR 4 tr) in 2007. Stock index futures are not available yet, as the China Financial Futures Exchange (CFFEX) still awaits approval from CSRC. Other derivatives include warrants, currency forwards and swaps, bond forwards, and interest rate swaps.

The Chinese stock market alphabet soup

Name	Currency	Description
A-shares	RMB	Companies incorporated in PRC Traded in Shanghai & Shenzhen Largest class of Chinese shares Investors: Chinese nationals and foreign institutional investors authorised under QFII
B-shares	USD/HKD	Companies incorporated in PRC Traded in Shanghai (USD) & Shenzhen (HKD) Investors: prior to Mar 01 only foreigners, now also domestic retail investors
H-shares	HKD	Companies incorporated in PRC Traded in Hong Kong
N-shares	USD	Companies incorporated in PRC, listed and traded on the New York Stock Exchange
L-shares	GBP	Companies incorporated in PRC, listed and traded on the London Stock Exchange
Red chips	HKD	Chinese companies incorporated outside PRC listed in Hong Kong Often state-owned or state-controlled companies
S-shares	SGD	Like H-shares but traded in Singapore

13

Vibrant growth in China's futures market



Source: PBoC

14

Phasing-out of non-tradable shares

Additionally, there is a distinction between "tradable" and "non-tradable" shares within the A-shares category, a distinction that dates back to the early years of the Chinese stock market. Prior to April 2005, only about 1/3 of shares from listed companies were tradable shares. The remaining 2/3 were not freely trading in the market but held by the government[9] or related entities. The non-tradable share reform, starting in April 2005, aimed at eliminating the difference between tradable and non-tradable shares while, at the same time, avoiding market disturbance due to the huge amount of "new" supply coming to the market. Appropriate compensation was therefore a core element of the reform and usually holders of non-tradable shares compensated those of tradable shares by giving out a portion of their shares at mutually agreed prices[10]. By the end of 2007, 1,300 listed companies – accounting for 98% of total market capitalisation – had either started or finished the reform process.[11]

However, the amount of floating shares – i.e. shares that can be freely traded on the secondary market and are not subject to any lock-up restrictions – is still very low. As of end-2007, the free float totalled less than 30% of all the shares outstanding[12].

9 KPMG (2007), p. 4.
10 CSRC (2008). China Capital Markets Development Report. China Securities Regulatory Commission. March 2008, p. 205f.
11 Ibid., p. 208.
12 Ibid., p. 240.

QFII

The Qualified Foreign Institutional Investor (QFII) scheme was introduced in 2002. The aim was to let foreign institutional investors participate in local stock and bond markets in order to bring more stability to the markets. By the end of 2007, 52 foreign institutions had obtained a QFII licence of which 49 had been allocated quotas totalling USD 9.995 bn. Five of the 13 banks permitted to provide QFII custodian services are foreign banks. QFII are allowed to invest in A-shares, bonds, and other financial instruments approved by the CSRC. Eligibility rules are established by the CSRC and include the following requirements:

Type	In operation, years	Paid-in capital, USD bn	AuM, USD bn
Fund manager	> 5	-	≥ 1
Insurance companies	> 30	≥ 1	≥ 10
Securities companies	> 30	≥ 1	≥ 10
Commercial banks	-	Ranked among top-100 banks globally by total assets	≥ 1

Source: www.fundcn.org 15

QDII

The Qualified Domestic Institutional Investor (QDII) scheme was introduced in mid-2006 in order to give approved domestic institutional investors the opportunity to invest in international, foreign–currency-denominated securities (fixed income, stocks, derivatives). The scheme had principally two goals: 1) to funnel abundant domestic liquidity abroad and 2) to stem appreciation pressure on the currency from rising foreign exchange reserves. By the end of 2007, 15 fund management firms and 5 securities firms had been granted QDII status with a total quota of USD 24.5 bn.

Market participants

In 2006, the investor structure of China's stock market was "still not desirable" according to the People's Bank of China[13] as institutional investors accounted for only 30% of the total market capitalisation. As of end-2007, retail investors still had a share of more than 50%[14]. Institutional investors generally play an important role in developing capital markets as they can help to channel (individual) savings into capital markets with a medium to long-term investment horizon and lower risk for investors, due to size and risk diversification. They can also add to product innovation and possibly improve market and pricing transparency[15].

The structure of institutional investors in the Chinese stock market differs markedly from that of more developed markets. As of end-2007, investment funds accounted for 52.7% of all institutional investor assets in China, followed by pension funds that had a share of around 40%. The share of the latter group is much higher in Japan or Korea, while insurance companies play a much stronger role in the US[16]. Investment funds offer only a limited range of products and have only weak innovation capability. Also, participation of insurance companies and social security funds is very low, which can be attributed to the low development level of the funded social security system. Domestic private equity funds are under-developed in China, which explains why foreign players dominate in this field in China. Last but not least, the complex regulatory environment for collective investment schemes hampers the development of institutional investors, as it raises costs and leads to efficiency losses. Currently there are three entities – CSRC, CBRC, and CIRC – in charge of regulating collective investment schemes in China.

This large share of retail investors and – accordingly – lack of sufficient institutional investors is widely seen as a problem. Retail investors are often linked to higher volatility, as herd behaviour prevails and people tend to act more sentiment-driven. However, there are also views that the share of "real" retail investors in China is lower than suggested by the numbers for individual stock trading accounts, as entities with close state linkages – like the military, police, local governments, state-owned enterprises and private funds opened such accounts in order to participate in the stock market boom[17]. Additionally, in the case of China, relatively low experience among traders and institutional investors might also have added to the build-up of the stock market bubble and heightened volatility. It would therefore not be sufficient only to increase the share of institutional investors. An improvement in financial literacy would also be desirable.

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[13] People's Bank of China (2008a). China Financial Stability Report 2007. March 2008, p. 44.

[14] People's Bank of China (2008b). China Financial Stability Report 2008. July 2008, p. 43.

[15] Kim, Yongbeom, Hi, Irene and Mark St Giles (2003). Developing institutional investors in the People's Republic of China. World Bank Country Study Paper. September 2003, p. 3ff.

[16] CSRC (2008). China Capital Markets Development Report. China Securities Regulatory Commission. March 2008, p. 273.

[17] China's Illusory Retail Investor Class. In BusinessWeek. June 7, 2007. Online: http://www.businessweek.com/globalbiz/content/jun2007/gb20070607_471221.htm?campaign_id=rss_as

Assessment of recent developments & outlook

Despite much progress...

Much progress has been made since the beginning of economic reforms in the early 1980s and with regard to China's capital market development. Reforms to the tradable–non-tradable share system as well as to the issuance process have been either completed or are well on track.

... markets are still small, ...

However, China's capital markets are still small, both compared to developed markets as well as to other emerging economies. Especially the corporate bond market is lagging behind, thus barring companies from tapping an important form of finance. Unified regulation and supervision are necessary to promote the development of corporate bond markets[18]. Additionally, trading platforms and clearing systems have to be unified in order to reduce extra costs for investors and encourage product innovation across segments[19].

... segments remain unbalanced and there is a lack of institutional investors

Furthermore, the bond market segments are unbalanced and fragmented, and the investor base in the stock market lacks institutional investors. The high share of retail investors with frequent trading behaviour poses risks to market stability. Also, it seems that institutional investors active in China's markets prefer short-term investment gains over longer-term investments. Therefore, it is necessary both to strengthen the role of institutional investors and also to embark on a general investor education programme. Additionally, the product range of investment fund companies is limited. This all makes a strong case for further concentrated efforts in terms of institutional and supervisory reforms, as well as increased foreign institutional investors' participation in China's local markets.

Regulators are aware of challenges and will continue with gradual reforms

The regulatory and supervisory bodies in charge seem to be aware of these challenges. Goals have been formulated aiming at continued improvement of China's capital markets. But one should not expect too much in the short run. The reform process of China's capital markets will most likely continue gradually, especially facing the most recent experience in industrial countries' financial markets. Looking back, this careful approach has worked well for China and is likely to provide a good basis for sustainable development in the future.

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[18] China Bond Market Review 2007. China Government Securities Depository Trust & Clearing Co. Ltd. January 2008, p. 39ff.

[19] CSRC (2008). China Capital Markets Development Report. China Securities Regulatory Commission. March 2008, p. 182.

China's banking sector to be tested by the downturn

Key recent developments

China's banking sector has undergone significant reform in recent years...

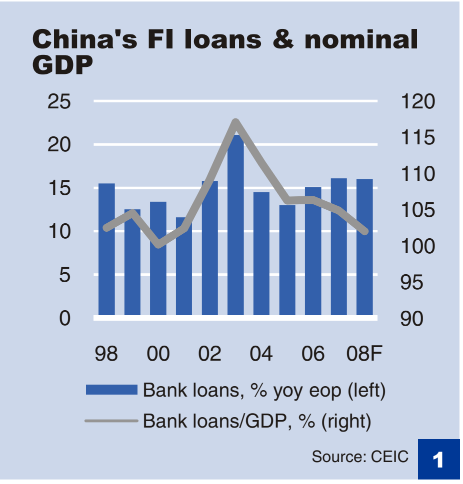
China's banking sector has undergone significant reform in recent years. The key banks, which include most of the state-owned banks[1] and the major joint-stock banks, have gone through internal reform, namely through capital injections from the state or new share-holders, ownership and internal structural changes which include having foreign strategic partners, and listing on the stock market.

... leading to improved financial fundamentals

Through the reform measures, the banking sector as a whole has emerged stronger and generally enjoys improved financial fundamentals. The capital adequacy ratio (CAR) of the banking sector was 8.4% in 2007, just above the basic 8% requirement of the Basel standard. The number of banks meeting the 8% CAR has risen through the years and together these banks account for around 80% of the banking sector assets.

Strong loan growth ensued as banks lent aggressively and grew their balance sheets again

Since almost all key banks are better capitalised and able to offload the bulk of non-performing assets off their balance sheets, years of strong loan growth ensued as these banks lent aggressively and grew their balance sheets again. Outstanding loans grew more than 200% during 2000-08. Nominal loan and nominal GDP both grew around 165% from end-2000 to end-2007. Despite efforts to slow bank lending in recent years, the loan/GDP ratio still stood above 100%. The most recent data shows that loan growth at end-2008 stood at almost 19% yoy, up from 16% at end-2007. This marks a reversal of credit policy, since prior to the worsening of the global financial crisis the Chinese authorities had been tightening monetary policy and asked banks to restrain loan growth. However, as the Chinese economy was slowing down progressively as reflected by 6.8% yoy GDP growth in Q4 compared to 11.2% in Q4 2007, the authorities switched to aggressive monetary easing and asked banks to continue lending.



Joint-stock banks have been the most aggressive. Their share of total banking sector assets climbed to 14% at end-2007, the second largest behind the state-owned banks (53%). Joint-stock bank assets grew at the dizzying pace of 33% in 2007, compared to the sector's average of 20% (state-owned banks 16%). City commercial banks have also seen strong asset growth (29% in 2007), accounting for over 6% of the banking sector's total assets.

Consumer lending has seen strong growth with mortgage loans being the largest component

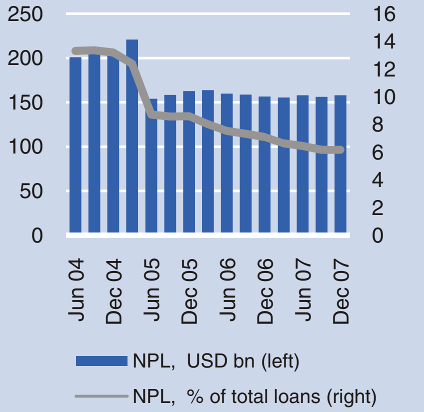
In terms of sector activities, consumer lending has seen strong growth in recent years. The share of consumer loans in total loans is estimated to have approached 20% in 2007. The largest component of consumer loans is mortgage loans, which account for more than 80% of consumer loans.

Although profit growth has been rising, profitability remains modest

Although the banking sector has in recent times reported rising profit growth, profitability as measured by return on assets remains modest at 0.9% in 2007. One of the factors constraining banks' profitability is China's regulated interest rates, resulting in very tight net interest margins. Furthermore, net interest income remains the main revenue source. Fee-based income from credit cards and wealth management products has been growing but still makes up a

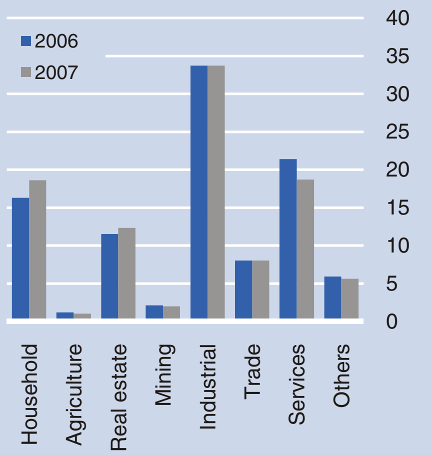
[1] Agricultural Bank of China, Bank of China, China Construction Bank, Industrial and Commercial Bank of China, Bank of Communications.

NPLs remain high in absolute terms despite falling ratio



Source: CBRC **2**

China's loans by sector
% of total loans



Source: Global Insight **3**

small portion of banks' earnings only. Non-interest income is estimated to contribute around 20% of total revenue.[2]

The official NPL ratio stood at 6.2% at end-2007, down from 16.6% in Q1 2004. The downward trend in NPL ratios has been driven by the transfer of impaired assets to special asset management companies and strong loan growth, which lowers the ratio despite NPLs remaining large in absolute terms. In absolute terms NPLs have declined significantly since 2004, but they rose slightly again in Q4 2007 to RMB 1,268.4 bn (USD 185.4 bn).

Other structural changes underway

Other developments are underway that will change the face of China's banking sector. Among them, the reform of Agricultural Bank of China (ABC) is yet to be fully carried out. The first step has begun with the announcement of a USD 19 bn capital injection from the government. ABC reform is one of the government's top priorities. Its reform plan may look different to the other big 3 banks as ABC's function as a key lender to the rural population cannot be weakened, but the goal of commercial independence will be the same. No timing of reform has been given, and it may be delayed yet again due to the current adverse global financial environment. In addition to ABC reform, mergers and consolidation of rural sector banks and co-operatives will take place to improve overall rural sector efficiency. The role of Postal Savings Bank (PSB) activities in lending against deposits will likely be expanded, playing a greater role in financial intermediation in the rural areas.

Reform is underway to separate the policy lending function of China Development Bank (CDB) from its commercial lending. Other policy lending banks, Agriculture Development Bank of China and China EXIM Bank, will likely follow suit.

Consumer banking

Consumer banking has been identified as having a very high potential in China. Household deposits have been a major source of cheap funding for banks, but households' potential as borrowers is yet to be fully explored. Consumer banking is still in an early stage of development in China. The population of 1.3 billion has savings deposits of almost RMB 2 trillion at end-2007, constituting a significant source of funding for banks. The share of consumer loans was around 20% of total loans in 2007. Mortgage lending makes up the largest share, around 80% of consumer lending. Other types of consumer lending such as car loans, debit and credit cards, as well as other household credit products remain relatively small.

Major players in consumer banking in China are the big-4 banks thanks to their large branch networks. However competition has been heating up as income from consumer banking, especially mortgage products, is seen as a generator of more steady long-term revenue, i.e. less cyclical than income from corporate banking. Joint-stock banks have been putting more emphasis on increasing their market share in consumer loans.

Assessing consumer credit continues to be challenging. The Credit Information Centre (CIC), under the purview of the PBC, acts as consumer credit bureau, and its scope of operations is still being expanded and evolving. Car loans, which make up less than 3% of

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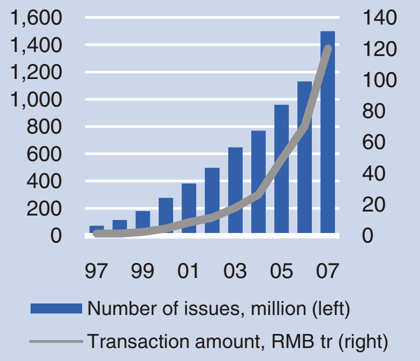
2 Asia Banking Outlook 2008, Moody's Global Banking Special Comment, June 2008.

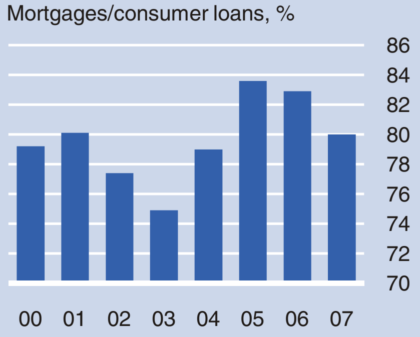
China debit & credit cards see explosive growth but still in early stage



Source: CEIC 4

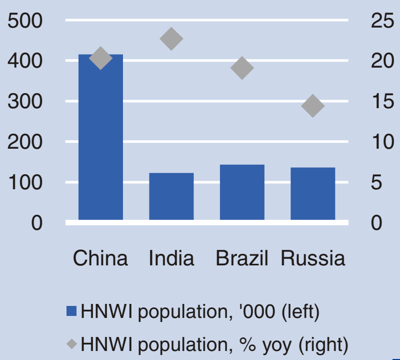
Mortgages make up around 80% of consumers loans

Mortgages/consumer loans, %



Sources: Moody's, PBC 5

China had highest HNWI population among BRICs in 2007



Source: Merryl Lynch World Wealth Report 2008 6

consumer lending, have seen a relatively high rate of defaults[3], implying that risk assessment and management need to be improved.

Credit card business is also among the subsectors identified as having a bright potential. At end-2007, there were around 90 million credit cards (6.8% of the population or 15.2% of the urban population). The number of debit cards is much larger at around 1.4 billion cards presumably due to multiple card holding, reflecting that Chinese customers are still cautious on spending on personal credit. Credit card business makes up less than 3% of consumer lending.

Foreign banks have also joined in the competition, capitalising on the internationally recognised brand names. Many of the foreign banks issue co-brand cards with their local partners to combine the international brand with local relationships[4].

As more banks are intent on gaining market share, competitive pressures have kept fee charges low. Banks are also trying to win over customers via the quality of services. Big local banks enjoy the advantage of having existing relationships with large local companies, which open doors to offering their employees card products. Foreign banks on the other hand have focused more on wealthy customers in the big cities. The lucrative segment for card products appears to be young professionals who are less averse to funding their spending on consumer credit. Given the low penetration rate of credit cards, the size of the pie for card business is yet to reach its full potential.

Mortgage lending has the potential to become the new staple for Chinese banks. The default rate for mortgage lending has thus far been lower than other consumer loans, similar to the experience of banking sectors in other countries. Furthermore, government measures have constantly favoured first-time home buyers and buyers of smaller housing, which counterbalance the measures to guard against speculative buyers. This coupled with underlying long-term demand, as supported by urbanisation and population trends indicating that another 350 million will become city-dwellers in China by the year 2030[5], suggests that long-term growth prospects for mortgage lending in China remain intact despite a looming property price correction.

Wealth management has enjoyed strong growth in China. The number of high net worth individuals (HNWI) in China is estimated to be the highest in non-Japan Asia at more than 400,000. Similar to credit cards, wealth management is another area where large local banks and foreign banks are keenly competing for market shares. Foreign banks have, at least up to the period before the global financial crisis in 2008, enjoyed advantages over local banks due to their international network and established brand names. The unfolding global financial crisis could erode this advantage and the regulatory authorities are likely to adopt a cautious approach on new product developments.

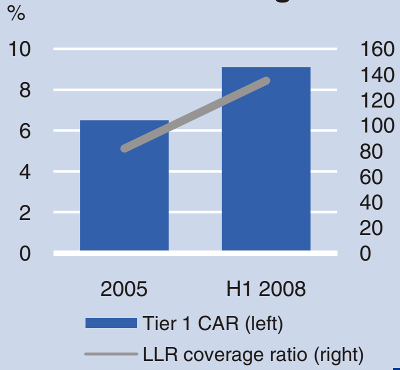
Challenges

An immediate key concern facing China's domestic banks is the impact of the economic slowdown on their earnings and profitability.

[3] Global Insight Report: China (Banking) 2008.
[4] For details see "Chinese financial markets in the global context – much growth, little integration" on pp. 17-22 in this report.
[5] By 2030 China's cities have to be equipped for at least 350 million new inhabitants, DB Research Talking Point, August 29, 2008.

Borrowers are facing increasing stress

China's listed banks Tier 1 CAR & LLR coverage ratio



Source: Fitch 7

Borrowers are facing increasing stress from several factors including slowing orders for exporters, rising labour costs and RMB appreciation (for exporters), the last two pressuring profit margins. In the past, Chinese companies have compensated for these margin pressures with a rise in sales volume, benefiting from strong demand globally. Now that is changing. The rise in borrowers' financial stress does not bode well for banks. Interest income from loans is estimated to account for more than 70% of China's banks operating income. As the economic cycle enters a downturn, delinquencies can be expected to rise.

H1 2008 data already shows that the amount of loans recorded as overdue from one day to one year increased at several key banks. The ability of banks to withstand the potential decline in asset quality during the downturn varies. Larger banks appear better able to absorb the deterioration in asset quality. In H1 2008, listed banks' average loan-loss reserve coverage ratio was 135%, improving markedly from 82% in 2005. The Tier 1 CAR of listed banks stood at 9.1% compared to 6.5% in 2005. Their pre-provision profit/average assets improved to 2.4% from 1.5% in 2005[6]. However, smaller banks are generally not as strong.

Exposure to the real estate sector is an area of concern

Bank exposure to the real estate sector is an area of concern. There are no official data on the banking sector's exposure to the real estate sector, but data from various reliable independent sources suggests that real estate loans (loans to developers and construction companies) make up around 12% of total loans. When taking into account mortgage loans, the banking sector's property-related loans are more than 20% of the total, a substantial exposure. There are unofficial reports that the real estate sector in some key cities is already slumping, for example in Shenzhen where prices dropped 30% yoy. The real estate loan portfolio is therefore vulnerable to a deterioration in asset quality. As past experience in other countries suggests, a drop in property prices dampens sales volumes, leading to tight cash flows for real estate developers and construction companies.

Banks tend to focus their lending on state-owned enterprises...

... as a result emerging SMEs have not had their financing needs served sufficiently

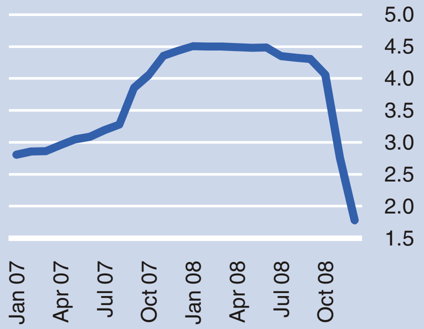
The corporate sector commands the largest share of bank loans, estimated at around 80% of the total. Within the corporate sector, banks tend to focus their lending activities on state-owned enterprises (SOEs) and large private companies, which often have government support. This is reflective of the past practice of state-directed lending, relationship-based credit decisions, and the general lack of confidence in counterparty credit outside the realm of the public-sector entities. As a result, the emerging small and medium-sized enterprises (SMEs) have not had their financing needs served sufficiently. Many SMEs have been relying on retained earnings and informal lending for funding needs. The People's Bank of China has become increasingly concerned that the SME sector is under-served. On the flipside, accounting standards at many SMEs are not on par with those at SOEs and large private companies, making it difficult, if at all possible, for banks to assess their true financial position, projection of future cash flow and ultimately their creditworthiness. In this regard, two areas need to be addressed simultaneously. SMEs have to improve their accounting standards if they want to access bank financing. Banks also have to develop expertise in SME credit assessment. For China to develop success-

6 Chinese Banks: Signs of Strain Emerging, Despite Strong H1 08, Fitch Ratings, September 22, 2008.

fully into a privately-driven economy, the SME sector must have proper access to bank funding.

Due to the PBC's past attempt to restrict lending growth, some banks resorted to selling a portion of their loans to trust companies of third parties or to banks' own SPVs (special purpose vehicles) in order to keep the loans on their balance sheets within acceptable levels. These loans were in turn repackaged into investment products typically sold to wealth management or corporate clients looking for higher-yielding instruments. According to a report by Fitch[7], the majority of the underlying loans sold by banks and repackaged into investment products are short-term discounted bills, working capital loans or loans with a short remaining maturity (the volume of loans sold and repackaged up to June 2008 is estimated to exceed RMB 400 bn). This is a source of discomfort even though banks' exposure to these loans is officially off the banks' books. Should investors, especially from the retail segment, face losses from these products due to a credit event, the regulator is unlikely to let them bear the full losses.

China's Shibor 3M during 2007-08



Source: Bloomberg 8

Chinese banks' exposure to the global credit turmoil is limited when set against Chinese banks' capital size. Only a handful of large leading banks have direct exposure to toxic credits in the US. Losses and provisions for losses have largely been accounted for and the final impact has been lower profits for these banks.

Fortunately, China's domestic liquidity and interbank funding have been able to function despite virulent global credit turmoil thanks to the presence of large domestic savings that have been the key source of funding for Chinese banks. Nevertheless, the general liquidity environment is tighter as the external surplus, particularly from foreign investment inflows, is getting smaller. The recent cuts in interest rate and bank reserve requirements reflect that the PBC's concern has shifted from controlling excess liquidity to providing sufficient liquidity.

Outlook

Past reforms put banks on a more stable footing to negotiate the downturn

The banking sector's progress in recent years has been driven primarily by government-initiated reforms and financial support as well as strong economic growth. These reforms, which have brought about more modern internal systems including risk management and IT, as well as a more commercially-driven business model, have put banks on a more stable footing to negotiate the downturn.

State is highly willing and able to support the banking sector

It would be unrealistic to expect China's banking sector to be unscathed by the global recession. The slowing economy will hurt the cash flow of the corporate sector, which will in turn lead to a rise in non-performing assets. The key to survive in this environment will lie in the strengthening of provisioning and the capital base in light of a potential rise in credit losses. The ability and willingness of the state to support the banking sector is high.

Consolidation of China's banking sector is yet to run its course

Consolidation of China's banking sector is yet to run its course. The process may be accelerated by the downturn, where the weakness of less financially sound banks will be exposed. It is important that in the long term Chinese banks continue to strive for prudent risk management, which as the experience of Western banks indicates is a crucial determinant of winners and losers. The future of China's banking sector is promising considering the economy's superior

[7] Ibid.

long-term growth potential and the still low penetration rate of the banking sector, particularly in term of consumer banking.

As regards the further opening up of China's banking sector, the outlook is not bright at least in the next 12 to 18 months. The regulator has been trying to ensure that the problems of Western banks do not spread to Chinese banks through exposure in inter-bank funding. The existing 20% cap on foreign investment in Chinese banks is likely to be kept until the situation at Western banks stabilises. China's regulator is also likely to tread carefully in the future with regard to the types of foreign investment products Chinese banks are allowed to invest in.

Syetarn Hansakul (+65 6423-8057, syetarn.hansakul@db.com)

Chinese financial markets in the global context – much growth, little integration

Dynamic financial market growth...

China has been an extremely interesting financial market for foreign market participants and investors, and is likely to remain so after the effects of the global financial crisis have waned.

Its attractiveness primarily results from the high catch-up growth rates that the Chinese financial sector has experienced in the past years, driven by a series of waves of market liberalisation, industry restructurings, introduction of new products and services, and a surge in demand for financial services.

... makes China attractive for foreign investors

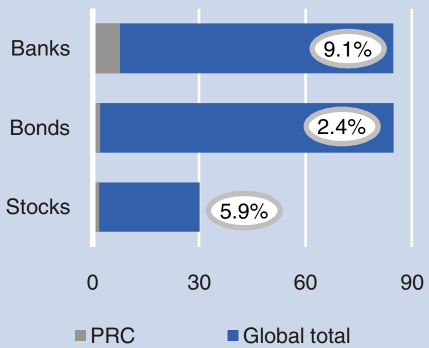
This combination of forces has unleashed an unprecedented period of growth for China's financial markets since the mid-1990s, in the course of which the country – along with Beijing, Shanghai and Shenzhen as its financial hubs – has become a preferred target for foreign investors and financial intermediaries. Nevertheless, China remains one of the most insulated financial markets in the global arena, and many market participants are hoping for greater integration with international financial markets.

In this chapter we review the market forces behind the quest of foreign financial services providers seeking to access the Chinese financial market, evaluate the current state of foreign activity, and discuss the prospects of further market opening.

China's financial markets – a magnet for foreign investors

Chinese financial markets in the global context

Bank assets (2007), debt securities outstanding (2008), stock market capitalisation (2008), PRC and global total, USD tr and PRC % of total



Source: DB Research 1

The motivation for the sustained interest by foreign investors and market participants in access to the Chinese financial sectors is the impressive growth performance in recent years. The development has been driven by three factors. First, the development reflects the potential for growth and efficiency gains among the suppliers in a financial market that until the early 1990s had effectively not existed. Second, market growth is driven by strong and rising demand for financial products, both in terms of volume and variety. Finally, supply and demand have been allowed to soar by the Chinese authorities in a remarkable – albeit controlled – process of de-regulation of existing domestic financial market structures, and an opening towards global financial markets[1].

The rapid growth that ensued in all segments of the Chinese financial market substantially heightened the weight of these market segments in the global financial arena. Thus, the total volume of debt securities outstanding is more than eight times as high today as only ten years ago, and makes up 2.4% of the global bond market. China's stock markets today make up 5.9% of the global total. And the Chinese banking market is among the largest in the world, representing almost 10% of the global total (see chart 1).

International integration is only getting started

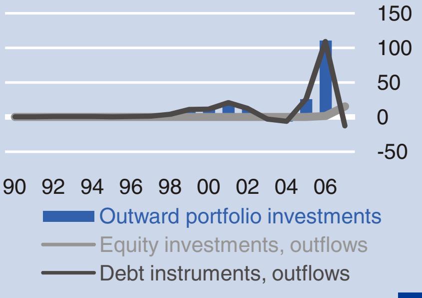
Integration into global financial markets remains limited

China's increasing share in global financial activity bears witness to the impressive growth of its capital markets in recent years. This share, however, does not give an indication about the degree of integration into global financial markets, i.e. the interaction of

[1] For details see "China's capital markets – structure and market development" on pp. 4-11 in this report.

Outward portfolio investments

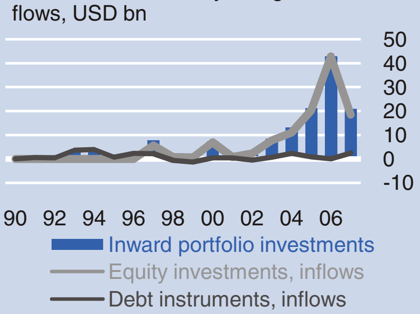
Outward investments by Chinese investors, flows, USD bn



Source: DB Research 2

Inward portfolio investments

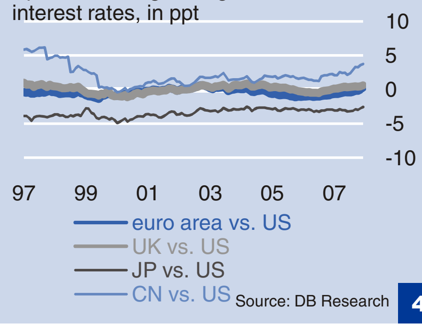
Inward investments by foreign investors, flows, USD bn



Source: DB Research 3

Sovereign debt spreads

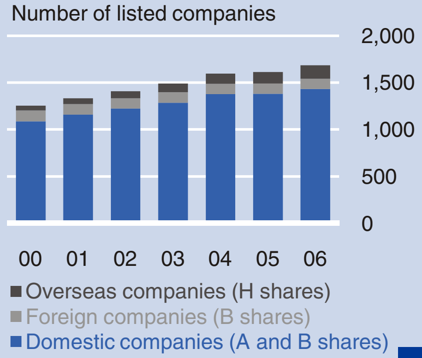
Spreads of long-term government bonds interest rates, in ppt



Source: DB Research 4

Structure of Chinese stock markets

Number of listed companies



Sources: PBC, DB Research 5

domestic markets with foreign markets and their openness towards the rest of the world.

In terms of market efficiency, the openness of a market to the global economy represents a crucial factor. For one thing, open markets and integration promote competition, which in turn puts downward pressure on prices and stimulates greater product choice. Secondly, integration enhances the markets accessible to service providers and enables them to realise economies of scale. This, too, encourages lower prices, greater product innovation, and more efficient risk management for financial firms.

In the case of China, financial market growth has largely been a domestic success, to a considerable degree independent from the far-reaching developments in global financial markets that have taken place concurrently over the past few years. This detachment is reflected in the still substantial price differentials between domestic and foreign financial assets, such as debt securities, and the comparatively low levels of activity of foreign participants in Chinese financial markets.

Securities markets

The international integration of Chinese securities markets has progressed rapidly over the past few years as illustrated by the fast-rising volumes of capital flows with the rest of the world. Portfolio investments by foreign investors in China reached a peak of USD 43 bn in 2006, falling back to USD 21 bn in 2007 (see charts 2 and 3). On average, foreign portfolio investments in China have increased by 51% annually over the past 5 years, reflecting the strong demand for securities from the country. At the same time, annual inflows amount to only 1.5% of total gross fixed capital formation in the country, and a mere 0.7% of total portfolio investments globally.

Despite the growth of cross-border investments in recent years, China's integration with international securities markets is only at a starting point. Price and volume indicators for bond and equity markets suggest that the cross-border flow of capital is far from efficient, and the additional benefits of a further opening to the global markets can be achieved.

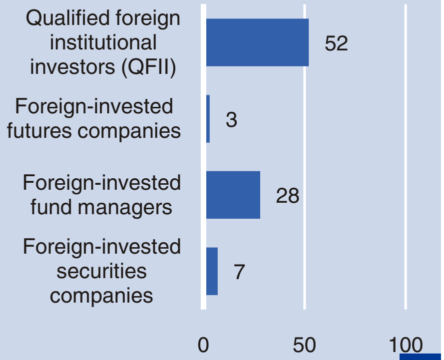
Price differentials of Chinese bonds compared to other debt securities traded on international markets are one indicator of the relatively low level of integration. While bond market spreads also reflect factors such as market liquidity, the risk assessment by markets about the general economy, the issuer and the specific debt instrument, they also document the relative costs to foreign investors of acquiring domestic securities.

In the case of China, money market and government bond spreads have remained high relative to other sovereign papers (see chart 4). Liquidity – relatively low volumes of issuance, turnover and single transaction sizes – and risk factors – as reflected by the country's sovereign rating relative to traditional industrialised or other emerging markets – have strongly contributed to these divergences, especially in the period of financial turmoil since 2008. At the same time, transaction costs related to Chinese sovereign bonds have remained high, contributing to these differentials.

The corporate bond market, as already pointed out, is still nascent with very low issuance volumes by international standards. Absorption of Chinese corporate debt by foreign investors is understood to be very low. Foreign companies registered in China, on the

Foreign participants in PRC securities markets

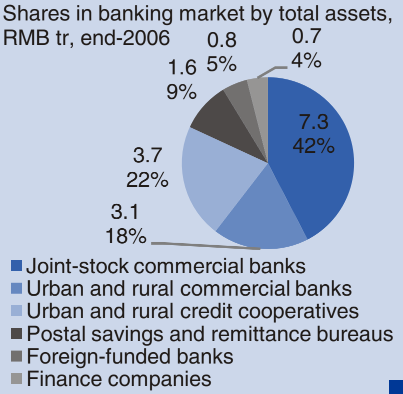
Number of foreign enterprises participating in PRC securities markets, end-2007



Sources: CSRC, DB Research 6

Size of Chinese banking market

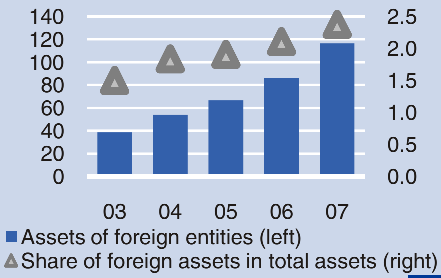
Shares in banking market by total assets, RMB tr, end-2006



Source: PBC, DB Research 7

Foreign bank assets

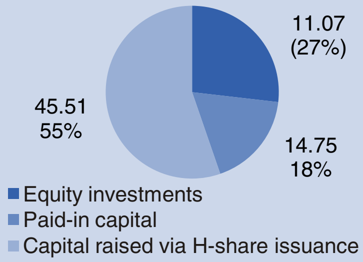
Assets of foreign banks in PRC, EUR bn and % of total banking assets



Sources: CBRC, DB Research 8

Foreign investments in Chinese banking

Foreign investments in PRC banking sector, USD bn, end-2007



Sources: CBRC, DB Research 9

other hand, have only recently been permitted to issue debt instruments, and no significant activity has been reported so far.

The international integration of the Chinese stock markets, in turn, has been characterised by its segmentation into three categories of shares, with different degrees of restrictions of access for foreign investors. Thus, the vast majority of companies are listed in so-called A-shares, which are listed on the Shanghai and Shenzhen exchanges and can only be purchased by domestic investors (see chart 5). Foreign investors have no access to these securities. B-shares – a much smaller segment of shares available in mainland China and denominated in US or Hong Kong dollars – can be acquired by a select group of appointed foreign institutional investors. Finally, only the very small segment of H-shares, which are listed in Hong Kong, can be freely accessed by international investors. With 1,434 companies listed under the A-share programme, 109 with B-shares and 143 with H-shares, the access of foreign investors to the whole range of equities in the mainland Chinese market is considerably limited. The impact of this limitation on prices is illustrated by the premium that investors purchasing H-shares of a company have to pay over the price of the A-shares of the same company. On aggregate, these premia, measured by the Hang Seng China AH Index, which comprises the largest and most liquid mainland China companies with both A-share and H-share listings, have risen considerably over the past several years. At early February 2009, the index stood at 144, suggesting that on average foreign investors had to pay a 44% premium over their domestic Chinese competitors. Prior to the financial crisis, this mark-up had reached more than 100%.

At the same time, the number of foreign investors licensed to operate on the mainland Chinese securities markets has remained limited. At end-2007, only 52 foreign financial services providers were licensed as Qualified Foreign Institutional Investors (QFIIs) (see chart 6). Other forms of financial services provision have remained confined to joint ventures of domestic companies, including three foreign-invested futures companies, 28 foreign-invested fund managers and seven foreign-invested securities companies.

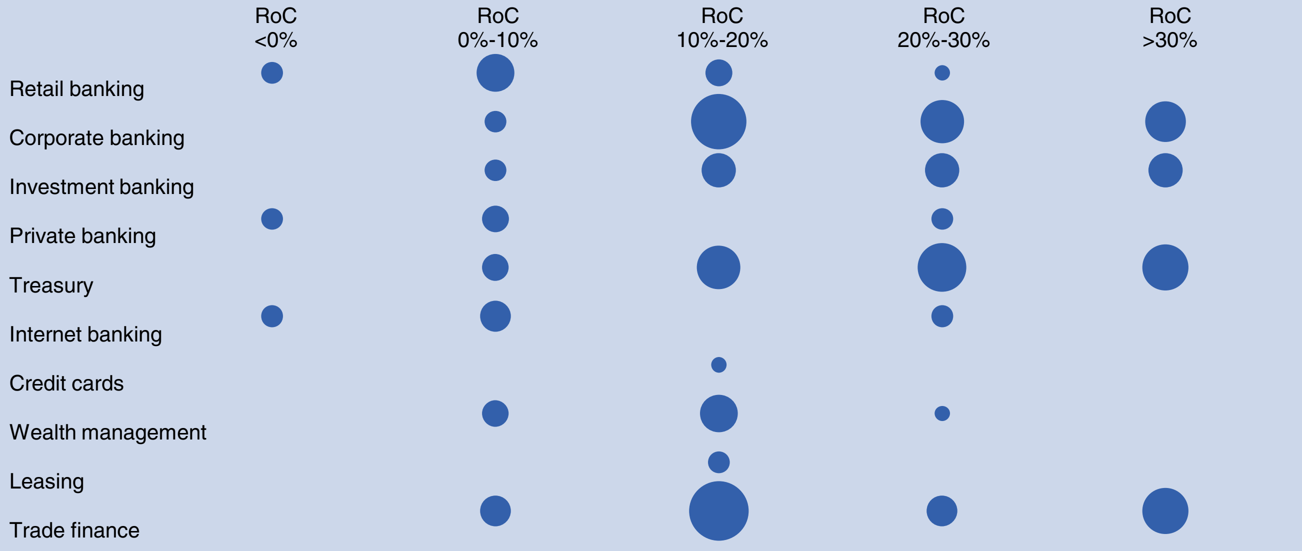
Banks

For the banking sector, too, integration into the global economy is a comparably novel trend. Having risen strongly since the admission of foreign commercial banking activities in China in the late 1990s, the volume of foreign banking assets in China amounted to EUR 117 bn by the end of 2007 (see chart 7). In relation to the entire banking sector, which remains dominated by the domestic banking system of joint-stock commercial banks (42% of total banking assets) and commercial banks and credit cooperatives (40% combined), the share of foreign bank assets, however, amounted to only 2.4% (see chart 8). This contrasts with 27% for the EU-25 and 11% for the US, suggesting that the degree of integration in the area of commercial banking is still rather low.

The activities of foreign banks in China are founded on a strong wave of financial investments which started in the earlier days of this decade, and today amount to a stock of more than USD 81 bn in cumulative terms. Less than one-third of this volume has been committed in the form of direct equity investments, and about one-fifth falls under the category of paid-in capital. More than half of the investments are capital raised via the issuance of H-shares (chart 9)

Profitability of foreign bank businesses in PRC

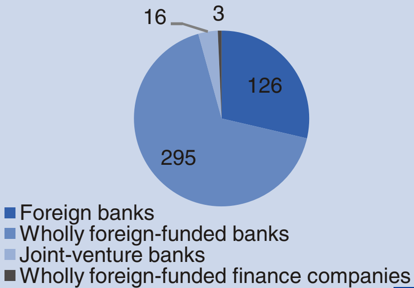
Profitability of selected banking businesses in PRC as assessed by foreign banks in terms of Return on Capital (RoC), 2008. Bubble size indicates number of foreign banks allocating RoC values to specific business areas.



Sources: PWC, DB Research 10

Foreign banks in PRC

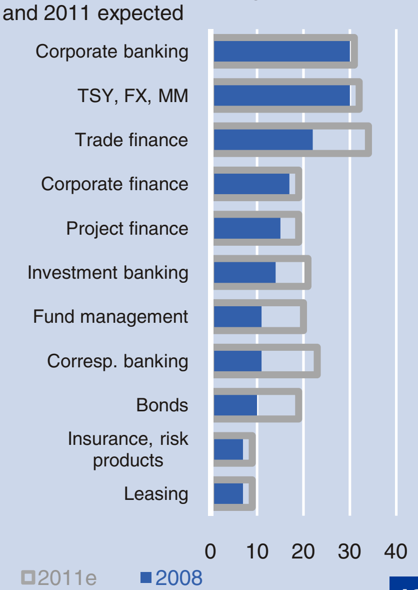
Number of branches and offices of foreign banks by type of legal entity, end-2007



Sources: CBRC, DB Research 11

Foreign banks in PRC wholesale banking

Number of foreign banks involved in Chinese wholesale banking, 2008 actual and 2011 expected



Source: PWC 12

The daily operations of foreign banks in China are run by 29 head offices of locally incorporated banks and their 125 branches, as well as 286 foreign bank branches and sub-branches. In terms of legal status, a total of 126 banks operate as foreign institutions, while a vast majority of entities is legally domiciled in China and wholly foreign funded (see chart 11).

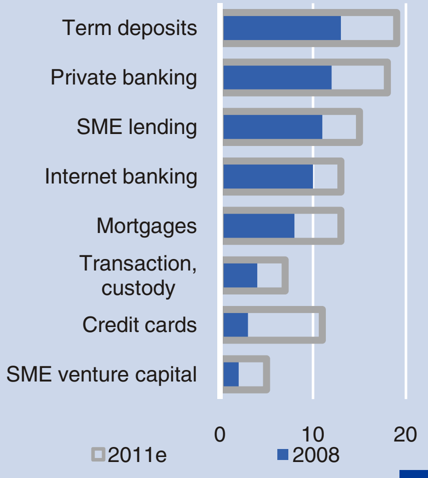
Against the background of the country's licensing scheme, foreign banks are mainly active in the area of commercial banking. In particular, the corporate banking business, treasury, foreign exchange and money market services, trade finance and corporate finance are quoted by the majority of foreign banks as their area of operative activity (see chart 12). A much smaller number of market participants are active in investment banking, fund management and other business areas. In the private banking area, the number of active foreign banks is lower still than in the wholesale business (see chart 13). A limited number of players are predominantly active in the provision of term deposits, general private banking services, lending to small and medium-sized business, and internet banking.

Even though comprehensive figures are not available, there is evidence that foreign banks in China can generate substantial profits from their operations in the country (see chart 10). Accordingly, a recent survey among the most important foreign operators[2] suggests that corporate and investment banking, treasury and trade finance services are business areas in which most market participants in early 2008 expected returns on capital in excess of 20%. The assessment by market participants, however, also shows that there is not only euphoria about the profitability of the Chinese financial market. No small number of market participants ascribed returns on capital of below 10% to the various market segments. Some even consider areas such as retail and private banking as not profitable at all.

[2] PriceWaterhouseCoopers (2008). Foreign banks in China 2008. Hong Kong.

Foreign in banks in Chinese private banking

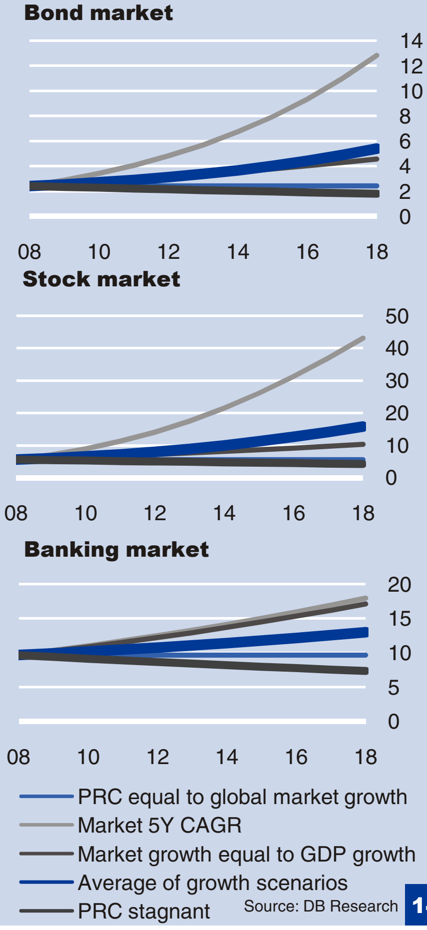
Number of foreign banks involved in Chinese private banking, 2008 actual and 2011 expected



Source: PWC **13**

China's future share in global financial markets

Scenarios for shares of PRC bond, equity, and banking markets in global total, by issues outstanding, market capitalisation, and bank assets, % of global total



Source: DB Research **14**

As optimism prevails, the majority of foreign banks surveyed on their operations in China indicated that they expected foreign banking activities in the country to be expanded substantially. In particular, investment banking, fund management and correspondent banking as well as virtually all areas of private banking are considered to be market segments in which an increasing number of foreign banks will seek to obtain licences and provide financial services. In terms of financial products, market participants consider derivative and structured products as well as debt capital market products as the most important growth drivers in the Chinese wholesale market. In retail, the mortgage business, credit cards and investment products are expected to be the up-and-coming financial services. In order to achieve institutional growth, the majority of market participants consider organic growth as the most attractive strategy, followed by the creation of new financial entities in the market. Other forms of expansion, including partnerships and joint ventures, are expected to be less promising.

China – a financial giant in the making?

China's financial markets have undergone an impressive transformation in the past two decades, starting at a unitary, state-run banking system, and today offering a large and – compared with just a few years back – efficient, diversified, liquid and stable financial market. Naturally, a key question is whether this progress will continue and how large and influential China's financial market will become.

Today, assessing this topic is probably more difficult than at any time over the past few years. Many important factors influencing the development of financial markets have become increasingly uncertain lately, and a number of key questions remain unanswered:

— Broadly speaking, will the Chinese economy continue to expand at the high rates seen in the past decades, thereby triggering the strong demand for financial products witnessed so far?

— Will the domestic financial markets retain their resilience so as to provide a solid basis for further expansion?

— Will regulators continue their strategy of market opening so as to enable efficient catching up to mature financial markets in terms of product ranges, market liquidity and efficiency of services provision?

— And finally, how will global financial markets develop after the financial and economic crisis?

These and a large number of more detailed variables are likely to influence the further development and relative size of China's financial markets on the world stage.

The country is likely to further increase its share in global financial markets, assuming that these markets emerge from the crisis with fundamental structures and mechanisms unharmed. Potential growth scenarios, however, differ widely depending on the basic assumptions about their development.

Thus, a continuation of growth rates as observed in the years 2003 through 2008 – even including the first market corrections in the wake of the financial crisis – suggests a further vigorous expansion that would make China one of the dominant financial markets in the world by 2018, alongside the US and the EU, with a 13% share in global bond markets, more than 40% of global stock markets and 18% of global banking markets.

China's global market shares to grow...

In a more moderate scenario, Chinese bond, equity and banking markets could – for example, if market opening came to a halt – lose their current dynamics and fall back to growth rates similar to their global counterparts, so that China's share in the global total in 2018 would remain constant at 2% of bond markets, 6% of stock markets and 10% of banking markets.

Similarly, it can be assumed that, in the long run, financial markets will grow at rates similar to the overall economy. In that case, Chinese financial markets would expand along a solid trajectory, leading to world market shares of around 5% of bond markets, 10% of global equity markets and 17% of banking markets in 2018.

If, at the opposite extreme, financial market growth ceased completely in the wake of the financial crisis and falling demand for credit and capital caused stock, bond and banking markets to get stuck at current nominal levels, the role of China in global finance may even diminish. In this case, its shares in the global total could recede to less than 2% in bond markets, 4% in stock markets and 7% in banking markets.

... to 5% in bond, 16% in stock and 13% in banking markets

Most likely, however, the truth will materialise between these extreme cases. Arithmetically, this average would bring China to market shares of 5%, 16% and 13% in the global bond, stock and banking market, respectively, by 2018.

Chinese banks can be expected to embark on international strategies soon

These simple calculations demonstrate that, even under rather conservative assumptions, China's share in financial markets is likely to grow, making the country not only an interesting investment location for the global financial industry but also one of the large single financial markets on the global stage. Most importantly, the country has already created banking giants which are among the largest banks in the world. It may not be long after the dust of the financial crisis has settled that these major players and other domestic financial firms will increasingly become internationally active[3] and truly challenge the established – and currently faltering – financial heavyweights.

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[3] For a detailed discussion see "Chinese financial institutions going global" pp. 33-36 in this volume.

Opening up China's financial markets – progress and prospects of regulatory liberalisation

Key events in China's financial market regulation

1948	Establishment of People's Bank of China (PBC) as monobank
1951	Renminbi (RMB) introduced
1979	PBC banking monopoly ends
1980	Assumption of seats at World Bank and IMF
1981	First issuance of treasury bills
1982	First issuance of local enterprise bonds
1984	PBC assumes role of central bank
1985	Approval of first foreign bank offices
1986	Membership in ADB
1988	Bankruptcy Law
1990	Establishment of Shanghai Securities Exchange
1991	Establishment of Shenzhen Securities Exchange
1992	Establishment of China Securities Regulatory Commission
1995	Commercial Bank Law
1995	PBC formally confirmed as China's central bank
1996	Membership in BIS
1998	Establishment of China Insurance Regulatory Commission
1999	Ninth National People's Congress designates financial reform as national policy reform goal
2001	Membership in WTO
2002	Introduction of QFII scheme
2003	Law on Banking Regulation and Supervision
2003	Establishment of China Banking Regulatory Commission
2004	Law of the People's Bank of China (amended)
2004	Administrative Measures on the Supervision of the Banking Industry
2004	Commercial Banking Law (amended)

Impressive growth figures, promises of high profits and the sheer unlimited potential of market opportunities have kept foreign financial market participants eager to participate in China's economic success over the past years. This interest continues as the financial crisis endures, considering that – with good GDP growth expected for the current and next year – the country remains a stronghold of economic dynamism in the emerging markets.

Whether and to what extent financial institutions from overseas will be able to participate in and contribute to China's economic development has been greatly influenced by the opportunities to access the country's financial markets. In the past, these opportunities have frequently been judged as limited by the regulatory burdens associated with opening, acquiring and operating financial operations in China. It is instructive that, in a recent business survey[1], foreign banks with operations in China ranked the regulatory environment as by far the most difficult aspect of the Chinese banking industry – ahead of key operating and business risk challenges that usually lead such rankings.

Even though such hurdles are perceived as grave impediments to a more efficient and competitive financial market in China, it is worthwhile noting that the country has pursued an unparalleled transformation of its financial sector over the past years. Not surprisingly, the survey quoted above finds that the regulatory environment is not only perceived by market participants as a burden, but at the same time also as by far the most important driver of change in the Chinese banking market.

In this article, we summarise China's policy of opening up its financial market to the global environment and its increasing participation in international financial market diplomacy, review the key structures of financial market regulation and consider potential future steps for further liberalising the financial industry.

China's strategy of market opening

China has – in the past decades – pursued an impressive course of creating a market-based financial system and opening it up to international financial markets, which as a parallel development were becoming increasingly globalised.

[1] PriceWaterhouseCoopers (2008). Foreign banks in China 2008, p. 24. Hong Kong.

Liberalisation of domestic financial markets...

Starting from a state-run banking system in which the People's Bank of China (PBC) had served as the monopoly supplier of financial services since 1948, the transition from a centrally-planned system to what has been termed a socialist market economy commenced in the late 1970s[2]. This included the termination of the PBC's banking monopoly and subsequently the creation of state-owned commercial banks, credit cooperatives and other state-owned financial firms. In the 1990s, the liberalisation process was accelerated, featuring the establishment of the stock exchanges in Shanghai and Shenzhen and the adoption of basic legal frameworks for the operation of banks and the issuance and trading of financial securities. In 1999, reform of the financial system was further reinforced, following the crisis in the domestic banking system and the need to digest heavy writedowns and legacy bad assets. This latest campaign resulted in the establishment of a separate regulatory and supervisory regime, composed of the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission, alongside the PBC as the institutional backbone of the financial system. These institutional changes were complemented by an overhaul of the existing legal framework and the adoption of a series of new laws and administrative measures governing the banking and securities industries. In doing so, the authorities were also keen to respond to a number of lessons learned in advanced industrialised economies about the governance of financial markets, including the need to run the central bank as a separate, independent institution, as well as the benefits of mandating separate, dedicated authorities with the regulation and oversight of the banking, securities and insurance markets.

... complemented by strategy of opening up to the outside world...

The Chinese government's strategy of creating a market-based financial system has also included a gradual opening up of the domestic system to the international financial industry. This strategy has been based on the insight that a transfer of expertise, especially in a market which has been developing as fast as the financial industry, as well as stronger competition can unfold substantial positive effects on the breadth, depth, diversity and efficiency of the domestic market. On that basis, the authorities embarked on a step-by-step admission of foreign banks and financial services providers to the domestic markets. Even though the licensing of foreign firms and products is still limited and highly regulated, banks and securities companies can now become operative in a number of market segments, and to a considerable extent invest in the domestic market.

... and characterised by cautiousness and circumspection

The process of opening up Chinese financial markets to the outside world has clearly been characterised by a great deal of cautiousness and circumspection. As global financial markets grew dramatically in the 1990s and the early 2000s, and the variety and complexity of financial products increased sharply, the Chinese leadership largely confined market access by foreign firms to wholesale investment and commercial banking services. Access conditions have remained strict, and the regulatory requirements put upon foreign firms have remained substantially above those applied to domestic financial companies, all of which have retained a substantial share of public ownership[3]. Complex financial instruments, such as derivative instruments or intricate financing structures, have

[2] See "China's capital markets – structure and market development" pp. 3-10 in this report.
[3] See pp. 7-9 in this report.

remained highly regulated for all market participants, and the regulatory authorities have been keen to maintain close control of market activities.

Growing international engagement and bilateral work on regulatory cooperation

Participation in global financial diplomacy...

As part of the policy of opening up financial markets to the global economy, the Chinese administration has intensified its participation in global financial market diplomacy.

... at multilateral level...

Commencing with China's membership in the World Bank and the International Monetary Fund (IMF) in 1980, the country subsequently became party to the major international and multilateral financial institutions, including the Asian Development Bank (ADB) in 1986, the Bank for International Settlements (BIS) in 1996, after having established business relations with the BIS as early as 1984, and the World Trade Organization (WTO) in 2001, following observer status since 1995 when the WTO was founded. China also belongs to the members of the G20, the group of the 20 most important industrialised and emerging countries. Starting in 2008, the country also participated in the International Working Group of Sovereign Wealth Funds.

... and through bilateral dialogues

In addition to these multilateral bodies, China has also engaged in a number of bilateral initiatives in the area of financial market policy. As the country's financial markets grew increasingly important in the 1990s, China also became increasingly attractive for other financial markets as a partner for bilateral agreements on preferential treatment and regulatory convergence. China, on the other hand, took advantage of the business opportunities and the exchange of regulatory and supervisory experience. The two most important of these bilateral initiatives are the EU-China Macroeconomic and Financial Markets Regulatory Dialogue (FMRD), which was launched in 2005 by the European Commission and the Chinese Ministry of Finance, and the U.S.-China Strategic Economic Dialogue (SED) between the US Treasury and the Chinese Ministry of Finance formed in late 2006.

EU-China Dialogue is a key driver for regulatory convergence...

The SED follows a broad approach to explore long-term strategic economic issues, including exchange and savings rates, developing efficient innovative service sectors, and exploratory discussions on a bilateral investment agreement.

... with its focus on key regulatory projects

The FMRD, in contrast, has taken a more focused approach, with a view to greater cooperation and convergence in regulatory and supervisory practices, including banking regulation and the implementation of the Basel II capital requirements framework, securities market regulation and questions of mutual market access, insurance regulation and the implications of the EU's Solvency II framework, as well as broader regulatory questions, including accounting standards and the implementation of the IFRS.

Market access and financial market regulation – key rules for foreign market participants

Access conditions for foreign firms have improved steadily

As a result of China's policy of opening up its financial markets for foreign firms, the conditions for market access by foreign firms have improved steadily over the past few years. Although clearly more limited than market access to traditional advanced economies and confined to only a few highly regulated inroads to the domestic market, entry into mainland Chinese financial markets today can be achieved by banks and financial investors in a number of ways.

Legal framework of China's financial market

Institutional and product licensing, conduct of business rules and prudential standards are governed by the legal framework that has been increasingly refined over the past decade.

The laws of most immediate importance for the conduct of financial activities are:

— the Banking Law
— the Funds Law
— the Insurance Law
— the Securities Law

Additional framework rules around financial services are contained in

— Anti-Money Laundering Law
— Regulation on the Administration of Futures Trading
— the Banking Regulation Law
— the Banking Supervision Law
— the Commercial Bank Law
— the Company Law
— the Foreign Exchange Administration Regulation
— the Measures on Administration of Domestic Securities Investment of Qualified Foreign Institutional Investors

Implementation of these laws takes the form of rules, notices, guidances and decrees issued either by the State Council or by one of the regulatory institutions.

At a broader level, the operative activities of financial firms are also covered by the general economic and commercial law of China, including

— the Anti-Monopoly Law
— the Corporate Bankruptcy Law
— the Enterprise State-Owned Assets Law
— the Foreign Economic Contract Law
— the Partnership Enterprises Law
— the Property Law
— the Regulation on Foreign-Funded Mergers and Acquisitions
— the Sino-Foreign Cooperative Joint Venture Law

Foreign banks

Foreign banks can enter the Chinese market in three ways:

— Banking licence: A foreign bank can apply for a banking licence in China. By end-2007, a total of 24 wholly foreign-funded banks with local banking licences were registered.

— Minority stake in domestic banks: A foreign bank can acquire a minority stake in a domestic bank. Foreign stakes in Chinese banks are limited to a maximum combined 24.99% share. A single investor can invest a maximum of 19.99%. Any foreign bank can hold minority stakes in a maximum of two Chinese banks.

— Joint ventures: Foreign banks can enter joint-venture agreements with domestic banks.

Foreign investors

A foreign portfolio investor can apply to the CSRC for the status of a Qualified Foreign Institutional Investor (QFII). As of end-2007, 52 foreign investors had achieved this status. As a QFII, a foreign investor – fund manager, insurance company, securities firm or other management institution – is subject to the following operating conditions:

— In order to qualify for QFII status, a fund management or insurance company must have a minimum five-year track record and at least USD 5 bn in assets. The thresholds for securities companies are 30 years in operation and USD 10 bn in assets, and for commercial banks USD 10 bn in assets and a rank among the 100 largest banking institutions worldwide by assets.

— The CSRC maintains a quota as a cap on total funds permitted to be invested by QFIIs, currently amounting to USD 30 bn.

— A licensed QFII can invest in A-shares, treasuries, convertible debt, or other financial instruments, including the purchase of shares through IPOs.

— In order to do so, the QFII has to cooperate with a domestic commercial bank which acts as a custodian of the financial assets acquired. The QFII has to maintain an account with the custodian bank operated on an RMB basis and the exclusive channel through which foreign capital can flow. At end-2007, 12 banks were approved conducting custodian services, five of which were branches of foreign banks in China.

— Remittances are subject to the approval of the State Administration of Foreign Exchange (SAFE).

— Trading has to be transacted via a domestic securities company.

— The maximum share a QFII can acquire in a domestic listed company is limited to 10% of the outstanding shares. Likewise, the maximum share of a domestic listed company permitted to be held by QFIIs is 20%.

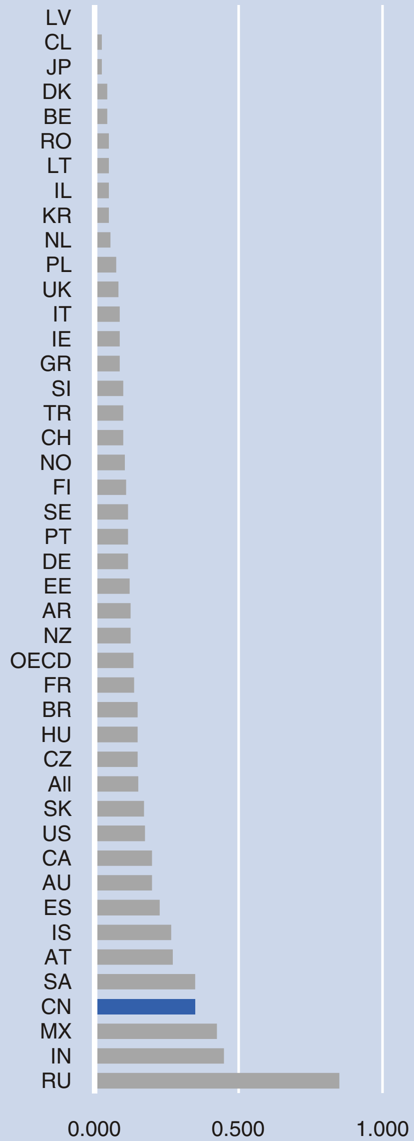
Non-QFIIs with limited access to Chinese securities

Unless licensed as a QFII, a foreign portfolio investor interested in investing in Chinese securities has two options:

— A foreign investor can seek a shareholding in a domestic securities or investment fund company. At end-2007, the CSRC reported seven foreign-invested securities companies, 28 foreign invested fund management companies and three foreign-invested futures companies.

FDI restrictiveness: Chinese insurance market

OECD FDI regulatory restrictiveness indicator, national insurance markets, end-2006, (0=open, 1=closed)



Source: OECD 1

— A foreign investor can resort to purchasing H-shares or a red-chip share – one of the 90 China-based companies registered outside the People's Republic and listed on the Hong Kong stock exchange – or in B-shares on the Shanghai and Shenzhen stock exchanges.

So-called foreign strategic investors – i.e. overseas investors seeking to acquire shares in Chinese companies as a direct investment with an operational purpose – have been allowed to purchase equity in state-owned or legal-person shares of Chinese listed companies since 2002. Such direct investments are subject to considerable restrictions[4]. Importantly, the Chinese companies with foreign shareholdings – so-called foreign-invested companies – have been granted permission to issue shares and bonds in mainland China.

Institutional framework

Admission of institutions and products to the Chinese financial market is subject to licensing by the supervisory authorities, which also define quotas and detailed conditions for the licences where this is required by the relevant law.

Following reforms in the 1990s, financial market regulation and supervision today is embedded in a two-tier, sectoral framework in which dedicated bodies act as regulators and supervisors. As the most important source of norms, the laws are adopted by the State Council.

The sectoral regulatory and supervisory bodies are subordinate offices to the State Council and implement the laws in their defined area of activity. In terms of regulation, they implement financial market laws by issuing rules, notices, decrees and guidances. In terms of supervision, they are in charge of the licensing of institutions and products and the oversight of the proper functioning the market and appropriate behaviour of market participants.

In the banking market these functions are fulfilled by the PBC and the CBRC. Securities markets are regulated and supervised by the CSRC. The insurance market falls within the realm of the China Insurance Regulatory Commission (CIRC). The basic setup, therefore, very much corresponds to the regulatory structure in the EU, where framework legislation is adopted by the Council and the European Parliament, while market regulation and the implementation of rules rest with the European Commission and the three sectoral regulatory committees, the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

In China, the three sectoral regulators-supervisors are complemented by other bodies entrusted with rule-setting and oversight duties, including the Ministries of Finance and Labour which together are in charge of the National Social Security Fund, the National Development and Reform Commission which supervises the debt securities markets, SAFE, the China Foreign Exchange Trade System, the China Government Securities Depository Trust and Clearing Corporation, the Anti-Monopoly Bureau (AMB) of the Chinese Ministry of Commerce, and other regulatory and self-regulatory bodies.

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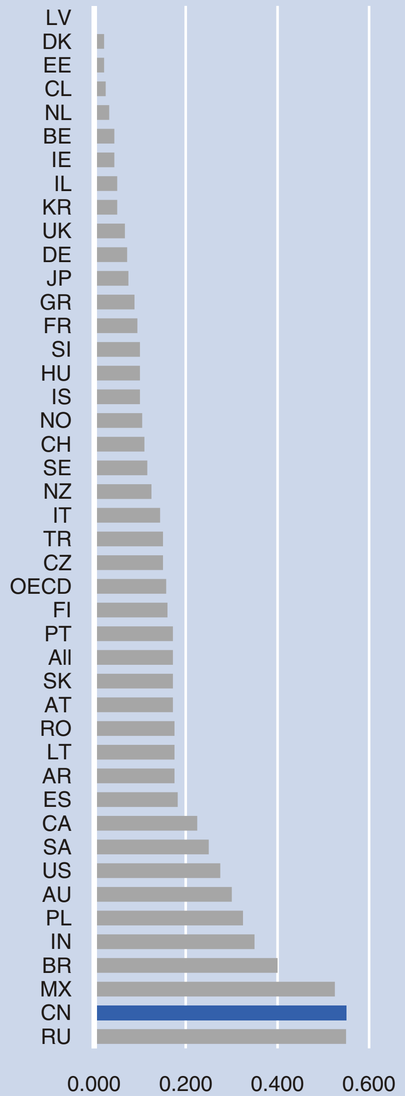
[4] For details see Steffen Kern (2008). SWFs and foreign investment policies. Deutsche Bank Research. Current Issues, October 2008. Frankfurt am Main.

Creating a level playing field – the concerns of foreign entrants

Market access remains limited

Despite the administration's work on dismantling the barriers, access to Chinese financial markets has remained limited. One indicator for this is the OECD's regulatory restrictiveness index which examines the regulatory hurdles for market access by means of foreign direct investments. By this measure, China performs as the fourth most closed insurance market (see chart 1), and as the second most closed banking market (see chart 2) among the advanced and emerging economies worldwide.

FDI restrictiveness: Chinese banking market
OECD FDI regulatory restrictiveness indicator, national banking markets, end-2006, (0=open, 1=closed)



Source: OECD 2

While respecting the country's cautious approach to market opening – especially at a time of global financial crisis – foreign market participants have identified a number of regulatory burdens on overseas banks and financial firms where they consider real progress for both sides, foreign firms and the Chinese financial market, achievable[5].

In the area of banking regulation, key practical improvements could include:

— Coordinated regulation and supervision

With the complexity of financial products and processes and the extent of reporting requirements growing, banks increasingly need to file with or seek approval from a multitude of authorities, including PBC, SAFE, SAT, CSRC, CIRC and others. For more efficient and consistent procedures, banks have asked for closer coordination among the relevant authorities and the establishment of one-stop filing and reporting procedures.

— Foreign debt lending

The ability of corporations and banks to borrow overseas has been limited by the authorities in order to balance the country's foreign debt and containing foreign currency speculation. At the same time, however, these quotas have come to constrain companies given the dramatic growth of their businesses, and banks in their foreign lending and liquidity management. Market participants therefore call for an extension of the relevant quotas and a deepening of onshore liquidity for banks by putting in place market-based means of funding.

— Ownership rules

After a five-year transition period following its accession to the WTO in 2001, China has been expected to eliminate all non-prudential ownership restrictions on acquiring stakes in domestic banks. Despite progress, market participants are uncertain about the legal status of such foreign invested banks, and to what extent domestic or foreign regulatory conditions would be applied, and have therefore called for a WTO-consistent clarification.

— Operating locations

Foreign banks are required to set up data processing systems in China before they can obtain a licence to issue bank cards. Against the background of the associated costs and the fact that such a step is not necessary to safeguard systemic integrity, market participants have asked to drop this requirement.

[5] For details see Steffen Kern, *SWFs and foreign investment policies*, Deutsche Bank Research, 2008.

— Branch network expansion

In order to expand their branch networks wholly foreign-funded banks are subject to extensive submission requirement for individual projects, and have asked the authorities to alleviate these reporting duties, e.g. by allowing multiple branch applications on an annual basis.

— Consumer finance restrictions

Foreign banks faced with regulatory hurdles, including...

Foreign banks are subject to extensive application procedures when issuing bank cards, such as credit cards, or specific personal loans. Market participants have therefore asked the authorities to clarify application requirements and criteria, and consider the establishment of dedicated credit card companies.

— Capital requirements

capital requirements, ...

Branches of foreign-funded banks are required to deposit 30% of their capital with domestic banks, putting them at a severe competitive disadvantage. Foreign banks have therefore asked to abolish the 30% deposit of working capital, and to reduce capital adequacy ratios or allow their consolidation across branches.

— Loan-to-deposit ratio

Starting in 2011, foreign-funded banks will be subject to a 75% loan-to-deposit ratio which is likely to put them at a competitive disadvantage owing to their limited branch network. Foreign banks have therefore asked to broaden the range of applicable deposits or abolish the 75% rule altogether, especially considering that other ratios to control lending expansion are already in place.

— RMB licences

... and licensing issues

Chinese authorities require branches of foreign banks to obtain a track record of three years of foreign-currency business, two of which profitable, before qualifying for an RMB licence. Again, this requirement has substantial competitive implications and foreign players have called for an outright abolition.

— Representative offices

Representative offices can be used by a foreign bank to conduct non-operational business such as liaison, market investigation and consultancy, related to its establishing a foreign bank. So far, only one representative office can be established by each foreign bank for the whole of China, and market participants have asked to abolish this limitation.

Foreign investment firms subject to...

In the field of securities market regulation, market access has remained very limited, and market participants have filed a number of requests for further opening:

— Securities and fund business

... ownership restrictions

The Chinese securities market has remained largely closed to foreign competition. Thus, foreign majority-owned securities or fund management companies do not exist. Similarly, the business volume of joint-venture securities companies is negligible. Also, foreign companies are prohibited from taking majority stakes in domestic fund management companies. Market participants therefore call for an abolition of the 33% limit and other restrictions on foreign ownership in securities joint ventures, and of the 49% limit on foreign ownership in joint-venture fund management companies.

— Bond underwriting

... and market exclusion

Participation of foreign banks in the domestic bond market is severely limited. Foreign banks are not allowed to buy or sell domestic bonds for final clients, trade commercial paper on the Chinese interbank market, trade asset-backed securities, or underwrite domestic financial or corporate bonds. Foreign players have therefore called on the authorities to terminate these prohibitions and introduce international market practices in the domestic bond market.

China still has a long way to go...

... but foreign investors remain optimistic

The list of proposals by foreign market participants suggests that China still has a way to go until foreign firms can operate in the domestic financial market on terms comparable to domestic firms. At the same time, they have remained optimistic about the prospects for an alleviation of the constraints against the background of the declared commitment by Chinese regulatory authorities to continue their policy of opening up, and thereby to broaden the choice of products available for the Chinese people, increase the efficiency and liquidity of markets and thereby reduce price levels across the industry, and promote the transfer of market expertise from international players to domestic firms.

The financial crisis and the future of market opening

Financial crisis burdens regulators

The key question is whether this commitment on the part of the Chinese authorities can prevail given recent events at international level. The financial crisis places a heavy burden on financial market regulators worldwide. It calls the effectiveness of existing regulatory and supervisory provisions in question, triggers examination of requirements for additional and new rules, and provokes a review of supervisory practices. Given the extent and speed of contagion as it spread across financial markets around the world, doubts on the merits of liberalising domestic financial markets and integrating them into the global economy are voiced repeatedly. Even though such arguments by and large miss the root causes of the financial turmoil, there is a risk that regulatory responses may be driven by nationalistic and protectionist perspectives on financial markets.

Chinese financial markets hit hard

This risk also exists in emerging markets such as China, which has only recently started to participate in global financial markets. China is being hit hard by the international financial crisis[6], even though it had taken a cautious approach to financial liberalisation and the degree of integration into global financial markets had been comparatively low.

Further market opening set to bring additional efficiency

But irrespective of the financial crisis, the benefits of liberal and open financial markets are evident, especially in countries such as China where unprecedented economic success over the past decades is largely attributable to improved financing conditions that were created alongside. Similarly, the increasing challenges of promoting private pension provision will only be possible to meet by ensuring efficient financial solutions.

China remains committed to market opening

Closing domestic economies off from the international environment would certainly be a wrong answer to the global challenges the advanced and emerging economies are facing. It is, therefore all the more reassuring that China remains committed to its policy of market opening and intensified international cooperation. Today, China plays a constructive role in the G20 process started at the

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[6] For details see “China’s banking sector to be tested by the downturn” pp. 12-17 in this report.

World Financial Summit in Washington on November 15, 2008. Recently, Premier Wen Jiabao made a strong commitment to open markets and international cooperation[7], proposing deeper international economic integration, a reformed international financial system, strengthened cooperation in financial market regulation and supervision, and closer global cooperation on broader economic, social and environmental concerns as vital ingredients for a new world economic order.

Regulatory convergence and supervisory cooperation with EU considered a key project...

In addition to crisis resolution, the growing importance of the Chinese financial markets that can be expected for the coming years suggests that far-reaching convergence of Chinese and international regulatory standards will be highly beneficial. This is particularly the case for China itself whose domestic market development could gain greatly if market access by foreign firms were not only facilitated by means of dismantling investment barriers, but also by eliminating regulatory differences. Given the current cross-border political initiatives, it is likely that the post-crisis regulatory environment will be characterised by a much stronger convergence of regulatory standards and supervisory practices globally than observed in the past. Joining in this process at an early point is set to bring particular benefits for China, as the country's financial markets regulatory framework is in the process of being developed and refined. Adjusting the domestic rules to international standards at an early stage can help to keep regulatory costs low, both on the regulatory as well as on the market side.

... based on tested cautious approach by China

With its recent participation in key international fora and its cautious approach to opening up its financial markets, China has made important advances. In particular, the dialogue with the EU has proved a valuable instrument for exchanging regulatory experiences. In light of new regulatory projects in the wake of the financial crisis at international level, and with a view to securing a maximum of cross-border coherence of financial market rules, China and the EU may find it useful to intensify this exchange and – without calling into question the merits of the watchful approach taken so far – work towards greater regulatory convergence and supervisory cooperation going forward.

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[7] For details see European Union Chamber of Commerce in China (2008). European Business in China Position Paper 2008. Beijing.

Chinese financial institutions going global

Introduction

Chinese ODI in commodities received attention in past years

The “going global” drive by Chinese corporations that started in the early 2000s has received considerable attention over the last couple of years[1]. The focus of these companies has mainly been to invest in resource-rich developing countries, mostly in Africa and Latin America, but also, to a lesser extent in developed countries like Canada or Australia. Aside from this commodity focus, investment also took place in the manufacturing sector. Here the main goals, presumably, were to acquire access to technology, management skills, brand names, and – to a lesser extent – to gain access to developed markets.

FIs' ODI marks a second wave of overseas investments

In what seems to be a second wave of Chinese outward overseas investment, financial institutions (FIs) like banks and insurance companies are also starting to go global. As for industrial corporates, a number of important questions arise from this development. These include:

— Who are the FIs that are investing abroad?

— What is the motivation behind this expansion?

— Is there an explicit government strategy?

— What are the implications for targeted companies abroad and recipient countries as a whole?

— Last but not least, what does the ongoing global financial crisis mean for Chinese FIs’ international investment activities?

Taking stock

Increasing internationalisation is not totally new...

The increasing internationalisation of Chinese FIs is not a totally new phenomenon. A recent study conducted by Boston Consulting Group (BCG)[2] finds that investing abroad by Chinese banks can be divided into two periods. In the first period between 1993 and 2005 there was on average one cross-border acquisition by Chinese banks per year, with the majority of the deals valued at below USD 20 m. Additionally, all of the deals were carried out in Greater China, i.e. in Hong Kong and Macau. Since the second period began in 2006, “deals have grown more frequent, far-flung, and sizeable.”[3] Between 2006 and mid-2008, there was a total of 11 deals, compared to 13 from 1993 to 2005. Since 1993, Chinese banks have invested almost USD 18 bn in overseas M&A deals, more than 80% of which since 2006. During the first period total M&A value amounted to only USD 2.8 bn. The most recent M&A activity also largely took place outside Greater China (see table below).

... but speeding up lately

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1 See for instance Lunding, Andreas (2006). Global Champions in Waiting: Perspectives on China’s overseas direct investment. Deutsche Bank Research. Current Issues, August 2006. Frankfurt am Main.

2 Leung, Frankie, Holger Michaelis and Tjun Tang (2008). Venturing Abroad: Chinese Banks and Cross-Border M&A. The Boston Consulting Group. September 2008.

3 Ibid., p.6.

Cross-border M&A deals of Chinese financial institutions: Speeding up lately

Chinese FI		Overseas target			Type of stake		Size of deal		Date
Name	State-owned (y/n)	Name	Type	Country/ Region	Majority	Minority	USD m	% stake	
Industrial and Commercial Bank of China (ICBC)	y	Union Bank of Hong Kong	Bank	Hong Kong	X		231	53%	Apr 00
ICBC	y	Fortis Bank (Asia)	Bank	Hong Kong	X		278	100%	Jan 04
China Construction Bank	n	Bank of America (Asia)	Bank	Hong Kong	X		1,200	100%	Aug 06
ICBC	y	PT Bank Halim	Bank	Indonesia	X		not dis-closed	90%	Dec 06
Bank of China (BoC)	y	Singapore Aircraft Leasing Enterprise Pte.	Leasing company	Singapore	X		965	100%	Dec 06
ICBC	y	Seng Heng Bank	Bank	Macau	X		586	80%	Aug 07
China Development Bank (CDB)	y	Barclay's	Bank	UK		X	3,000	3%	Aug 07
ICBC	y	Standard Bank	Bank	South Africa		X	5,600	20%	Oct 07
China Minsheng Banking Corp.	n	UCBH	Bank	US		X	317	5%	Oct 07*)
BoC	y	The Bank of East Asia	Bank			X	506	5%	Nov 07
Ping An Insurance Company	n	Fortis	FI	Belgium/ Netherlands		X	2,700	4%	Nov 07**)
Ping An Insurance Company	n	Fortis Investments	Asset management	Belgium/ Netherlands	X		3,000	50%	Mar 08
BoC	y	La Cie. Financière Edmond de Rothschild	Bank	France		X	378	20%	Sep 08
China Merchants Bank	n	Wing Lung Bank	Bank	Hong Kong	X		2,500	53%	Sep 08

*) Plans to increase to 9.9% in 2008 and 20% in June 2009, totalling USD 317 m for the first two phases, first investment in US bank

**) Stake has been raised to 4.99% totalling USD 3.2 bn

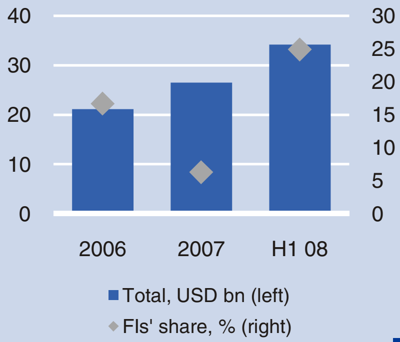
Sources: News reports, companies' statements, BCG, McKinsey, CBRC 1

A small number of Chinese FIs are relatively active in pursuing foreign investment in the form of M&A. State-owned banks dominate in terms of deal frequency as well as deal value. Since 2006, state-owned banks like Industrial and Commercial Bank of China (ICBC), Bank of China and China Development Bank (CDB) have accounted for more than 50% of the total disclosed deal value. But joint-stock commercial banks, like China Merchants Bank or Minsheng Banking Corp., have recently stepped up their expansion abroad as well. This coincides with the pattern for total outbound M&A across all sectors where around 75% are acquisitions by government-controlled entities[4]. Aside from buying into peers abroad, Chinese FIs have also increased the pace of their greenfield investment

[4] Luedi, Thomas (2008). China's Track Record in M&A. The McKinsey Quarterly No 3 2008, p. 80.

activities. By the end of 2007, Chinese banks had opened a total of 60 branches and subsidiaries in 29 countries around the globe with combined assets of USD 267.4 bn[5].

China's outward FDI continues increasing
Flows



Sources: Mofcom, DB Research
2

Putting M&A activity by Chinese FIs into perspective

Between 1995 and 2007, Chinese outbound M&A deals reached a value of roughly USD 65 bn altogether, of which 1/3 or USD 21 bn came from the oil and gas sector. The financial services sector accounted for close to USD 20 bn (30.3%), making it the second most important source (in terms of value). All other sectors trailed behind by a wide margin[6]. Official statistics on outward foreign direct investment (FDI) show a somewhat smaller share of FIs in China's total outward direct investment. Until 2007, FIs had a share of 14.2% in the total outward FDI stock. In 2007, the direct investment outflow from the financial services sector totalled USD 1.7 bn, compared to USD 26.5 bn for all sectors. Banks' outward investment made up the lion's share, accounting for 95% of total flows from the financial services sector in 2007[7]. However, as shown in chart 2, outward direct investment flows from the financial services sector tend to be more volatile than total outflows. The share in total direct investment outflows dropped to 6.3% in 2007, down from almost 17% in 2006. Figures for the first half of 2008 suggest that the share has risen sharply, reaching 1/4 of China's total outward direct investment flows for that period.

Why invest abroad?

Chinese banks getting more weight
World ranking based on tier-1 capital

	2008	2007
ICBC	8	7
Bank of China	10	9
China Construction Bank	13	14
Bank of Communications	54	68
Agricultural Bank of China	71	65

Source: The Banker "Top 1000 World Banks"
3

The developments in China's financial services sector and especially in the banking system over the past decade[8] explain why China's banks have the money to expand abroad. Following a period of balance sheet clean-ups and recapitalisation, non-performing loan (NPL) ratios dropped to relatively low levels of slightly above 5%, from more than 20% in the early 2000s. Strong foreign interest in Chinese banks has led to huge sums in IPOs, and most of the larger Chinese banks successfully attracted one or more strategic foreign investors. Together with deposit growth outpacing credit growth, this has made them cash-rich, enabling Chinese FIs to invest abroad. ICBC and Bank of China are among the top 10 banks worldwide. Within Asia-Pacific, four Chinese banks are among the ten largest banks, as measured by tier-1 capital (see table on the left).

Chinese banks' overseas greenfield investment is also motivated by similar reasons as for FIs from developed markets, namely following key customers as trade activity increased, offering financial services to Chinese MNCs and diversifying revenues. Also, the acquisition of capabilities (like for instance general and risk management) seems to play an important role.

In addition international M&A activity of Chinese FIs can be broadly separated into two categories. Financial investments on the one

[5] China Banking Regulation Commission (2008). 2007 Annual Report. June 2008, p. 40. Online: http://zhuanti.cbrc.gov.cn/subject/subject/nianbao2007/english/ywqb.pdf
[6] Luedi (2008).
[7] 2007 Statistical Bulletin of China's Outward Foreign Direct Investment. Ministry of Commerce of the People's Republic of China / National Bureau of Statistics of the People's Republic of China / State Administration of Foreign Exchange, September 2008 (in Chinese). Online: http://hzs.mofcom.gov.cn/accessory/200809/1222502733006.pdf
[8] See "China's banking sector to be tested by the downturn" on pp. 12-17 in this report.

hand and more strategically motivated ones on the other, including a number of motivations similar to those mentioned above for green-field investments. Some studies on this topic find that the improvement of skills especially in the area of risk management is top priority for an overseas investment[9].

A unified and explicit government strategy seems not to be in existence

It seems unlikely that there is a unified and explicit government strategy that encourages Chinese banks and insurance companies to invest abroad. While the Ministry of Commerce continues to promote "going global", statements by officials and recent experience with failed deals (due to missing/refusal of approval at home) could hint at growing unease within the political leadership regarding the relatively rapid and uncoordinated expansion of Chinese FIs abroad.

Not all the deals of the past are successful

Also, from a business perspective not all the past deals have been successful. Leung et al. (2008) note that Chinese banks will face some scepticism from their shareholders as they might see outward FDI as a costly action without long-term benefits. This has in some cases to do with a lack of a clear strategy and rationale for overseas investment, translating into the challenge of extracting longer-term value from M&A deals. The authors conclude that Chinese banks (as any other company) have to develop a clear strategy, including a) a rationale for venturing abroad, b) an idea of what targets to aim for, and c) how to pursue the deals, including bidding and integration.

Outlook

Global economic crisis and lower growth in China also affect Chinese banks' earnings in 2009

As explained in the section on China's banking sector developments, the global economic recession and markedly slower growth in China will also negatively affect Chinese banks' earnings and profit outlook in 2009. Additionally, some of the recent investments abroad have started to turn sour, as Western financial institutions experienced trouble, received capital injections from the government, or were even nationalised.

This will also lead to slower international expansion in the near term

In the near-term this will likely lead to much slower international expansion by Chinese FIs. In addition to less "cash richness", resistance at home might grow, meaning that regulators will be more hesitant in granting approval for overseas investments. In addition, shareholders might become more reluctant to approve M&A deals solely based on the fact that the necessary "firepower" is there. Rather, a more strategic and long-term orientation is likely to dominate.

Over the medium term much will depend on how the global economic system evolves from the crisis

Over the medium and longer term much will depend on how the global economic system evolves from the crisis. If protectionist tendencies strengthen, this would also dampen international expansion of Chinese FIs. Political resistance in developed markets will probably also remain relatively high, as domestic banking systems are seen as vital for the home economy, thus limiting the scope for larger-scale takeovers not only by Chinese FIs despite local players being in trouble.

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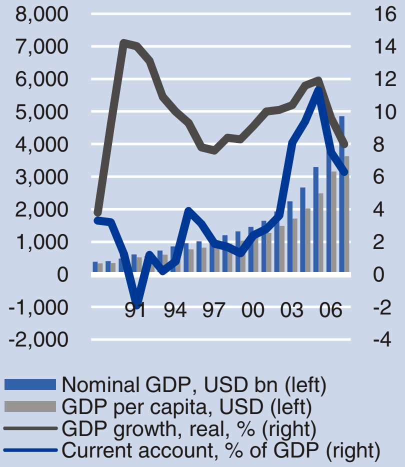
[9] Ngai, John & Yi Wang (2008). Global Investment Strategies for China's Financial Institutions. The McKinsey Quarterly, June 2008.

Economic progress

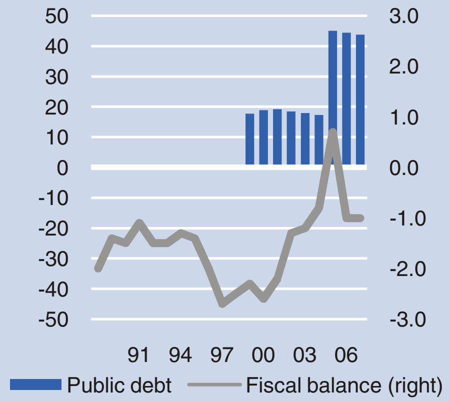
PRC, nominal GDP in USD bn, per-capita GDP in USD, nominal GDP growth in % yoy, current account as % of GDP



Source: DB Research 1

Stable public finances

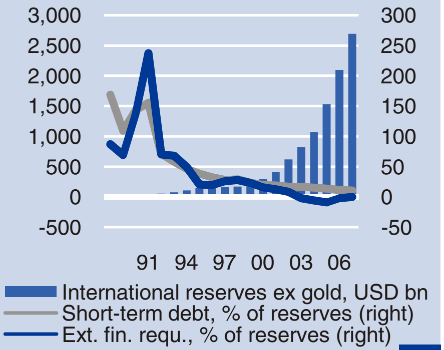
PRC, public debt as % of GDP, fiscal balance as % of GDP, official figures



Source: DB Research 2

Large reserves

PRC, international reserves excluding gold in USD bn, short-term government debt as % of reserves, external financial requirements as % of reserves



Source: DB Research 3

The Chinese state – a global investor

Investments by state-owned investment vehicles have attracted great attention lately. In particular, they have busied financial dealmakers, policymakers, economists and the academic community since mid-2007 when the scale of the investments by sovereign wealth funds and their potential influence in conjunction with the emergence of new investors, especially in the emerging markets was realised by the wider public.

China and its foreign investments have figured prominently in this debate. For one thing, the country commands formidable financial resources for pursuing foreign investments. With the creation of the China Investment Corporation, a sovereign wealth fund (SWF), announced in mid-2007, the country gave a clear signal it was about to pursue cross-border sovereign investments more systematically than in the past. At the same time, the lack of detailed information about the objectives and concrete investment projects of CIC and other vehicles under the command of the State Council gave rise to uncertainty in the recipient countries, especially in the US and Europe. Speculation was fuelled by prominent investment cases of the past – especially the failed takeover of Unocal by CNOOC in the US[1] – as well as China's growing appetite for natural resources and the measures by the Chinese state in the recent past to secure access to these commodities.

Today, China is one of the largest sovereign investors in the world, working through a number of state institutions on a wide variety of asset classes. This article reviews the sources of China's financial strength, the evidence on its investment activities and the political environment in which cross-border investments are embedded.

Sources of sovereign funds in China

China's rising investment activities on the global stage are based on the country's rising wealth which allows it to set aside funds for domestic and foreign investments. The motivations for doing so are fourfold. First, China can save and profitably invest current excess revenues for the benefit of future generations, especially in case the current rise in the country's competitiveness and prosperity should wane over time. Second, China can improve its participation in the global economy, taking advantage of attractive comparative returns and business opportunities potentially related to these investments. Third, it can reach a better diversification of its revenue streams and asset portfolio, reducing potential concentration risks. Finally, China can reduce its accumulation of foreign exchange reserves and put them to more efficient use.

In practice, China can currently draw on massive economic resources as a basis for its investment activities. Following years of high and sustained economic growth (see chart 1) driven by a strong export performance, China has consistently achieved strong current account surpluses since the mid-1990s.

The capital inflows from these surpluses are reflected in the dramatic accumulation of foreign exchange reserves over the past decade (see chart 3) – the largest single reserves portfolio in the

[1] For details see Sovereign wealth funds – state investments on the rise (2007). Deutsche Bank Research. Current Issues. September 2007. Frankfurt am Main.

world, representing more than one-third of the global stock and currently about to surpass the two-trillion threshold.

Chinese reserves show staggering growth...

Importantly, these reserves can largely be regarded as net surpluses given that the level of public liabilities is very moderate, with public debt below 50% and a low fiscal deficit. As a result, the short-term debt and external financial requirements relative to the level of reserves have been falling steadily, reaching 12% and -2% this year, respectively.

... set to continue, albeit at a slower pace

Assuming a reasonable continuation of the economic success of the Chinese economy in the coming years, Chinese current account surpluses can be expected to prevail. Thus, foreign exchange reserves are set to grow further, possibly amounting to USD 2.7 tr by the end of 2009. Not surprisingly, the funds for investing state vehicles are abundant, and the Chinese state has earmarked USD 200 bn alone for its newly established SWF.

Chinese state investment vehicles

Chinese state invests through various vehicles

The Chinese state has used various public vehicles to pursue international investments in the past. The most important of these institutions are four entities maintained by the central government: the state's official sovereign wealth funds, the development bank, the central bank and the authority administering the country's foreign exchange reserves.

China Investment Corporation (CIC)

Major investments by CIC

Most important shareholdings by name, country, sector of target, volume (EUR m) of investment and share (%) in target capital

Morgan Stanley	US	Finance	3,850	9.9
Blackstone Group LP	US	Finance	2,222	10.0
VISA	US	Finance	77	0.1
China Railway	CN	Other	75	NA
JC Flowers PE Fund	US	Finance	NA	80.0

Source: DB Research 4

The China Investment Corporation (CIC) is the latest financial entity founded by the Chinese State Council and was created in 2007 as the PRC's official sovereign wealth fund. Established as a wholly state-owned company and headquartered in Beijing, the CIC has been mandated to make long-term investments that maximise risk-adjusted financial returns on behalf of the Chinese state.

The CIC's funds originate from special bonds issued by the Chinese Ministry of Finance in September 2007 which raised RMB 1.55 tr and were used to acquire USD 200 bn of China's foreign exchange reserves.

The CIC maintains that, not least because its financing is grounded in financial instruments and subject to commercial obligations, it follows a strictly commercial orientation and is driven by purely economic and financial interests. The CIC claims that it usually does not take controlling stakes or seek to influence operations in the companies in which it invests, but rather holds, manages, and invests its mandated assets to maximise shareholder value with a long-term approach.

CIC with broad investment mandate

In doing so, CIC investments are not limited to a particular sector, geography, or asset class and include equity, fixed income, and alternative assets. Investments can be undertaken domestically[2] or internationally, and may be pursued by CIC directly, or by mandated external fund managers. Beyond asset management, the CIC's activities also include the provision of loans through entrusted financial institutions, the management of entrusted foreign exchange

[2] Equity investments in domestic financial institutions are primarily undertaken through the CIC's subsidiary, Central Huijin Investment Ltd. (Central Huijin). The holdings include legacy assets from the 2003 recapitalisation of state-owned commercial banks, for which Central Huijin had originally been founded, and the Chinese state's shareholdings in the country's major financial enterprises, including the Industrial and Commercial Bank of China, Bank of China and China Construction Bank.

assets, the establishment of equity investment funds and fund management companies as a promoter, and other businesses approved by the relevant governmental authorities.

USD 80 bn earmarked for overseas investments

Out of the CIC's initial endowment of USD 200 bn, up to USD 120 bn is expected to be used for domestic shareholdings and further restructuring and recapitalisation of Chinese financial institutions[3]. Only an estimated USD 80 bn, it is understood, will be used for overseas investment. About one-tenth of this share of the portfolio has been used to make a number of landmark direct investments, including shareholdings in Morgan Stanley, Blackstone and Visa. In addition, the CIC is working with external fund managers to assist in the management of its international investment portfolio (see chart 4).

As the PRC's official SWF, the CIC has been represented in the IMF's International Working Group of SWFs and was involved in developing the Generally Accepted Principles and Practices in 2008.

Major investments by CDB

Most important shareholdings by name, country, sector of target, volume (EUR m) of investment and share (%) in target capital

Barclays Plc.	UK	Finance	2,329	3.2
Tuntex Plc.	TH	Chemicals	22	10.0
Bangkok First Investment and Trust Plc.	TH	Finance	15	59.0
Century Securities Co.	JP	Finance	15	20.1
Tisco Finance Public Co. Ltd.	TH	Finance	12	15.7
Korea Microw ave Co. Ltd.	SK	Electronics	9	21.6

Source: DB Research 5

China Development Bank (CDB)

China Development Bank (CDB) is the PRC's central development bank under the leadership of the State Council. Its primary objective is to promote China's competitiveness and living standards.

The CDB primarily fulfils traditional functions of development banks, including the raising and channelling of funds for economic development, the promotion of public projects in the areas of infrastructure, basic and high-technology industry, urbanisation, SMEs, agriculture, rural communities and farmers, education, medical and health care and environmental protection, and the support of domestic enterprises in their international expansion by means of international cooperative activities.

At the same time, the CDB has repeatedly acquired stakes in foreign enterprises. Among a number of small commitments, the CDB's stake in Barclays Bank Plc. is the most prominent example of its investment activities. Figures about the volume of funds within CDB for foreign investments are not available (see table 5).

People's Bank of China (PBC)

China's central bank, the People's Bank of China (PBC), also ranks among the *de facto* investment vehicles of the central government.

Major investments by PBC

Most important shareholdings by name, country, sector of target, volume (EUR m) of investment and share (%) in target capital

BG Group Plc.	UK	Energy	186	0.5
Prudential Plc.	UK	Finance	168	1.0
Hong Kong Note Printing Ltd.	HK	Other	5	15.0

Source: DB Research 6

Mandated with the formulation and implementation of the country's monetary policy, and the safeguarding of financial stability, the PBC primarily pursues conventional central-bank functions. Beyond those, the PBC is also entrusted with participating in international financial activities and performing other functions specified by the State Council. Presumably with a view to the latter, the PBC has acquired shares in a number of overseas enterprises primarily in the financial sector, but also in energy. Prominent examples include stakes in the UK's BG Group – a large gas supplier – and Prudential (see table 6). Like in the case of CDB, no information is available on the volume of funds earmarked for such investments.

State Administration of Foreign Exchange (SAFE)

SAFE acts as state investor

In close coordination with the PBC, the State Administration of Foreign Exchange (SAFE) manages the foreign exchange reserves of the PRC. Compared with other countries' reserves holdings, the

[3] Central Huijin was acquired by CIC for a reported USD 67 bn. Another USD 50 bn of the CIC's initial USD 200 bn endowment are understood to have been earmarked for further restructuring of state-owned financial institutions.

Major investments by SAFE

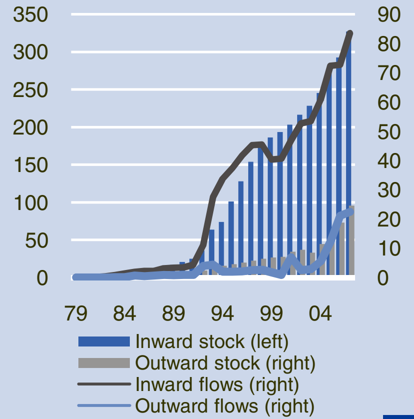
Most important shareholdings by name, country, sector of target, volume (EUR m) of investment and share (%) in target capital

Total SA	FR	Energy	1,877	1.6
BP Plc.	UK	Energy	1,297	1.0
Australia & New Zealand Banking Group Ltd.	AU	Finance	120	1.0
National Australia Bank Ltd.	AU	Finance	120	1.0
Commonwealth Bank of Australia	AU	Finance	120	0.3
Aviva	UK	Finance	NA	1.0
Royal Dutch Shell Plc.	NL	Energy	NA	1.0
BG Group Plc.	UK	Energy	NA	0.7

Source: DB Research 7

Chinese FDI

Foreign direct investments with Chinese participations, inward and outward, stocks and flows, USD bn



Source: DB Research 8

PRC's foreign exchange reserves are the largest worldwide, amounting to USD 1,906 bn at end-November 2008. China not only manages almost a quarter of total global reserves. With SAFE investing these reserves mainly in highly liquid international assets, it also holds one-fifth of all US Treasury securities outstanding and is understood to be absorbing more than half of all net new US Treasury security issuance.

Beyond the management of these reserves and the assistance to the PBC in operating the country's balance of payments and exchange rate system, SAFE has also become in recent years an active state investor, using reserve assets to build up stakes in a number of high-profile enterprises, most importantly in the finance and energy sectors. These include participations in Total, BP, Royal Dutch Shell and Aviva (see table 7).

Chinese state investments in perspective

Together, the four central government entities are understood to have undertaken equity investments in excess of EUR 12.5 bn abroad in recent years, predominantly in the financial and energy sectors.

The total volume of foreign investments by Chinese state entities may, however, lie well above this figure. For one thing, the four state investment vehicles do not publicly report their investment activities. As a result, the relevant statistics are likely to be incomplete. Second, the four investment vehicles are only a small fraction of a wider range of entities which are wholly or partly state-owned enterprises and which pursue overseas investments for operational, financial or other reasons. These entities include:

— a vast number of state-owned Chinese enterprises and their foreign shareholdings and subsidiaries, including five of the world's 100 largest transnational enterprises and five of the world's ten largest banks,

— development organisations, such as the CDB's China-Africa Development Fund,

— and funds established to cover social security and pensions liabilities, including the National Council for Social Security Fund.

These state-owned entities are understood to pursue investments in bonds, equity, real estate and other assets within China and abroad. The total volume of foreign investments by Chinese state vehicles has not been publicly disclosed, but is likely to be a multiple of the investments undertaken by CIC, CDB, PBC, and SAFE. The total volume of foreign direct investments by Chinese public and private enterprises amounts to USD 82 bn over the past ten years, and it is likely that a substantial part of these investments was undertaken by state-owned entities (see chart 8).

These foreign investments are important for China. They stand for the impressive efforts the country has made in pursuing its strategy of "going global". They reflect the considerable financial resources public and private investors have amassed in recent years and the resolve of enterprises and state investors to participate in globalisation not only as producers of goods and services but also as investors and owners of natural and productive resources (see table 9).

Chinese multinational enterprises in the global economy

Chinese corporations among the w orld's Top-100 transnational companies, ranked by foreign assets, 2006*)

	Foreign assets	Foreign sales	Foreign staff	TNI
CITIC Group	17,623	2,482	18,305	19
China Ocean Shipping Company	10,397	8,777	4,432	39
China State Construction Engineering Corporation	6,998	4,486	25,000	30
China National Petroleum Corporation	6,374	3,036	22,000	3
Sinochem Corporation	5,326	19,374	220	48
Lenovo Group	3,058	9,009	5,800	47
China National Offshore Oil Corporation	1,741	1,818	1,500	9
China Minmetals Corporation	1,266	2,527	630	12
China Communications Construction Corporation	1,162	2,855	1,078	9

*)Foreign assets, foreign sales in USD m. Foreign-based employees in absolute numbers. TNI: UNCTAD Transnationality Index, a composite index of 3 ratios: foreign assets to total assets, foreign sales to total sales, foreign employment to total employment.

Source: UNCTAD 9

China at starting point with foreign investments

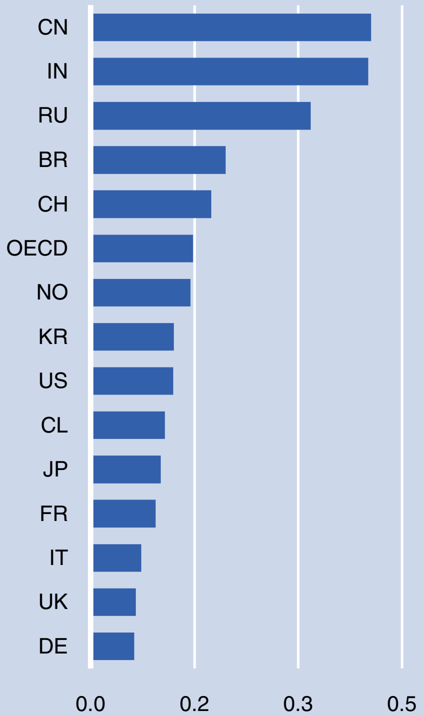
At the same time, it becomes clear that China is at an early starting point with its investment activities, be they public or private. Thus, the EUR 12.5 bn believed to be directly invested by the four central government agencies in recent years as well as the total of USD 82 bn that public and private entities from China have invested abroad in the past decade are still very small by international standards. The total volume of global foreign direct outward investments stands at nearly USD 1,997 bn every year, USD 1.1 tr of which is invested by EU residents alone. In 2007, China's outward direct investments – state and private – amounted to USD 22 bn, just over 1% of the global total.

A similar picture emerges from the bilateral FDI relations between China and the EU. In 2007, the EU exported EUR 7.1 bn in capital to China, or 1% of total EU investments abroad. China, in contrast, invested a mere EUR 616 m in the EU over the same year, i.e. less than one-twelfth of EU capital exports, and 4% of China's aggregate foreign investments.

If anything, these data show that foreign investments between China and the rest of the world need a strong boost in both directions. Although the growth of China's foreign investments has been robust for a number of years, it is evident that their level is far from commensurate with the role the country already plays in terms of global output and trade.

FDI regulatory restrictiveness

OECD regulatory restrictiveness index (0=open, 1=closed), end-06



Source: OECD 10

The political environment for Chinese foreign investments

Investments by state-owned vehicles are by no means a phenomenon specific to China. State-owned enterprises, public pension funds and SWFs are operated by many states around the world. Especially SWFs had given rise to considerable public debate in the US and Europe over the past year, reflecting concerns in the recipient countries – justified or not – over the implications large cross-border investments by government entities may have in terms of financial stability, non-financial motivations behind the investments, a feared sell-out of strategic assets, or the adherence to legal and corporate governance standards in the host economy.

China has repeatedly been referred to in this debate as one case in point, owing to the size of state assets in principle available for investments, the establishment of CIC as a separate vehicle dedicated to sovereign investments and the uncertainty among

SWF GAPP – The Santiago Principles

Generally Accepted Principles and Practices (GAPP) as agreed by the International Working Group of Sovereign Wealth Funds (IWG) and endorsed by the IMF's International Monetary and Financial Committee on October 11, 2008*)

1. Sound **legal framework** for the SWF and its relations with other state bodies
2. Clearly defined **policy purpose**
3. **Coordination** with domestic fiscal and monetary authorities
4. Clear policies, rules, procedures, or arrangements regarding **funding**, withdrawal, spending operations
5. Timely **statistical reporting**
6. Sound **governance** to facilitate accountability and operational independence
7. Setting of **objectives**, appointment of governing bodies, oversight by owner
8. Clear **mandate**, adequate authority and competency for governing bodies
9. **Independent operational management**
10. Clearly defined **accountability** framework
11. **Annual report and financial statements** on operations and performance, in accordance with international or national accounting standards
12. Annual **audit** of operations and financial statements
13. Clearly defined professional and **ethical standards**
14. Dealing with **third parties** based on economic and financial grounds
15. Operations in **host countries** in compliance with all applicable regulatory and disclosure requirements
16. Public disclosure of **governance framework**, and provisions for operational independence
17. **Financial information** to be publicly disclosed
18. Investment policy based on **sound portfolio management principles**
19. Investment decisions to **maximise risk-adjusted financial returns** – or otherwise clear definition and public disclosure of other considerations
20. No seeking or taking advantage of **privileged information** or inappropriate influence by government in competing with private entities
21. Respect for **shareholder ownership** rights
22. Framework for **operational risk management**
23. **Reporting** of assets and investment
24. Regular review of GAPP **implementation**

*) International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds – Generally Accepted Principles and Practices*, Washington, October 11, 2008

many observers regarding the objectives behind the growing investment activities. In addition, policymakers in recipient countries have expressed discomfort with the fact that China is seeking free access to the markets in which it intends to invest, while at the same time largely denying free market access to foreign investors in its own economy. China, these critics point out, is leading the league table for restrictiveness against incoming investment worldwide, as reflected in the country's top position on the OECD's foreign direct investment restrictiveness index (see chart 10).

Policymakers have responded to the broad concerns on the rise of cross-border state investments with two major policy initiatives, aimed at what are commonly perceived as the most important causes of the irritations, namely the lack of information in financial markets and recipient countries regarding the objectives and activities of SWFs, and the fragmentation of investment policies in recipient countries around the world.

Guidelines for SWFs – the Santiago Principles

On October 11, 2008 the International Working Group of Sovereign Wealth Funds (IWG) issued the results of its work since its establishment on May 1, 2008. The IWG has presented a set of 24 Generally Accepted Principles and Practices (see text box), also known as the Santiago Principles, which are designed as a voluntary framework and which are subject to home country laws, regulations, requirements, and obligations. These should provide guidance for appropriate governance and accountability arrangements, as well as guide the conduct of appropriate investment practices on the part of SWFs.

The success of reaching agreement on the GAPP marks an important step. China, in particular, could benefit from the new rules. It has played a constructive and leading role in drawing up the GAPP, underlining its commitment to greater transparency and good governance in its investment activities. And the Principles have the potential for greatly facilitating foreign state investments since they offer a first fundament for greater trust between sovereign investors and the recipient countries. After all, subscribing to the GAPP could become a cachet among SWFs signalling to recipient economies that the entity is committed to financially-motivated investments and fulfils minimum standards in terms of transparency and governance. Conversely, it cannot be excluded that an SWF deciding not to embrace the GAPP will in practice be confronted with heightened political scrutiny or even resistance in the recipient economies compared to those SWFs participating in voluntary self-regulation as stipulated by the GAPP.

Whether the Santiago Principles will in practice become such a seal of quality critically depends on the seriousness with which they will be applied. For one thing, it is open whether the GAPP can satisfy the expectations of the various stakeholders, including policymakers in SWF home countries and in recipient economies, as well as market participants and the wider public. If the GAPP fail to address the key concerns of the main parties to future investment transactions, there is a risk that they will become ineffective and SWFs will continue to face difficulties finding access to certain economies and being accepted as reliable institutional investors. Finally, the viability of the GAPP depends on the ability of the IWG and the IMF to succeed in overseeing and ensuring their implementation.

Towards more open and coherent investment policies

Rules for foreign investments in recipient countries...

In response to the rise of international state investments and the associated concerns, many countries have adjusted their domestic investment policies, i.e. the rules governing the entry conditions of foreign investors. Important examples are the amendments to the CFIUS process in the US, the FIRB review in Australia, the adoption of the Law on Foreign Investments in Companies Having Strategic Importance for State Security and Defence in Russia as well as the draft amendment to Germany's Foreign Trade Act.

... have remained national prerogative

These measures reflect the fact that rules for foreign investments have remained a national prerogative. In practice, economies worldwide are separated from each other in terms of foreign investments by substantial regulatory barriers in the form of direct and indirect hurdles (see chart 11). This discourages important investments, or – if they are nevertheless undertaken – substantially raises the cost, especially considering that the barriers differ widely from country to country and no general patterns exist.

China has strong interest in open market access

Investors, including public and private actors in China, have a strong interest in free access to the markets in which they intend to get engaged. The vast number and increasing severity of investment barriers stand in the way of these capital allocations.

With protectionist reflexes against foreign state investors in potential recipient countries looming, the finance ministers of the G7 have asked the OECD to examine possibilities to provide principles for foreign investment policies.

OECD standards provide important guidance, ...

In response to this mandate, the OECD recently issued its Declaration on Sovereign Wealth Funds and Recipient Country Policies, calling for

— No protectionist barriers to foreign investment in recipient countries

— No discrimination among investors in like circumstances

— Investment restrictions only to address legitimate national security concerns, and subject to the principles of transparency, predictability, proportionality to clearly-identified national security risks and accountability

— Adherence to OECD General Investment Policy Principles, including, in addition to the above, progressive liberalisation, commitment to not introducing new restrictions and unilateral liberalisation.

... but their effectiveness depends on various factors, including:

These principles and the detailed guidance the OECD provides are important yardsticks for national investment policies. To what extent they will lead to success in terms of more open and harmonised investment regimes is a different question which critically hinges on four factors.

Political climate

— First, on the political climate. Following the benign international conditions in the 1990s, further market opening has faced increasing opposition in recent years and months. General concerns over the impact of globalisation and concrete national and sectoral protectionist interests in many economies have considerably weakened the political momentum for further liberalisation of capital movements.

Application

— Second, on their application. The OECD guidelines are nothing more than guidelines, effectively leaving political application to national governments, so the degrees of commitment and the ways of implementation and enforcement are likely to vary.

On the one hand it has to be recognised that the OECD will be using its peer review process to promote adherence to the standards. But the recent dramatic rise in the economic importance and volumes of foreign investments warrants a much stronger commitment by national governments that should result in binding rules along the lines of trade agreements under the WTO.

Symmetry of market access

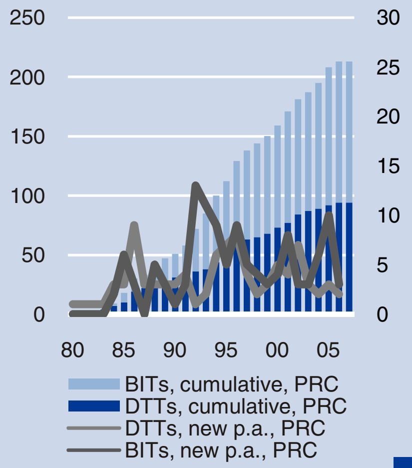
— Third, on the symmetry of market access. Cross-border investments not only suffer from high regulatory barriers per se, but also from the asymmetric way in which many economies pursue foreign investments and benefit from open markets elsewhere while maintaining restrictive rules on inward investment. This is counterproductive, and policymakers should work towards reducing these asymmetries.

Scope

— Finally, on their scope. OECD guidelines have only a limited geographical reach and primarily address the traditional industrialised countries. It is encouraging that the OECD has made special efforts in its SWF-related work to include some 20 non-OECD countries in its discussions and intends to maintain and enhance this dialogue going forward.

Legal basis for global investments

Number of Bilateral Investment Treaties (BITs) and Double Taxation Treaties (DTTs), PRC



Sources: UNCTAD, DB Research

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Conclusion

Market access, to be sure, is a particularly relevant issue for China. China also has a strong interest in free market access given the increasing number of foreign investment projects that its public and private enterprises pursue on the global stage. In this respect, the improvements which the OECD principles stipulate in terms of open and more uniform investment policies in the traditional industrialised economies – some of the most interesting targets for Chinese investors – promise better investment conditions for its investment vehicles going forward.

Whether China reciprocates by participating constructively in the dialogue with the OECD, providing more open rules for foreign investors in its own jurisdiction, remains to be seen. With its work on establishing bilateral investment and taxation agreements over the past few years and its renewed commitment to opening up to the world economy, China has fulfilled important preconditions for such a contribution.

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