CHINA's ENTRY INTO THE WTO AND THE FINANCIAL SECTOR

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To open the banking industry is essential part of the basic policy of the China Open Reform. Starting from late 70's of the last century, the degree of openness of the Chinese banking industry has been increasing. Since joining the World Trade Organization (WTO) on January 1, 2002, the People's Bank of China began to enforce the commitments made by the Chinese government by adopting the so-called open policy to further enhance the openness of the Chinese banking industry.

By the end of the 5-year transition period, China will treat foreign banks as national banks. In real terms, all the above means that according to the agreements made, China is committed to comply with the following regarding the operation license, the renminbi business and the foreign currency business of foreign banks:

1. Operation Licenses

Within 5 years after China's accession, all current unnecessary measures regarding the ownership, the operation and the establishment of foreign banks, as well as those concerning their branches and restrictions on issuing licenses, will be cancelled.

2. Foreign Exchange Business of Foreign Banks

All restrictions on the target customers to foreign banks in dealing foreign exchange business are supposed to be already cancelled. Foreign banks may immediately offer comprehensive foreign exchange services to Chinese enterprises and Chinese citizens, without examination and approval of individual cases and may be permitted to develop the business of foreign exchange, inter-bank loan, the issue of foreign exchange credit cards and foreign credit cards agency.

3. Renminbi Business of Foreign Banks

Foreign banks are permitted to develop the business of cheque clearing, collections and payments and safe deposit boxes.

Geographical restrictions on renminbi business of foreign banks will be cancelled in stages:

(1) The opening of Shenzhen, Shanghai, Tianjin and Dalian

(2) On 1/1/2003, to open Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan

(3) On 1/1/2004, to open Jinan, Fuzhou, Chengdu and Chongqing

(4) On 1/1/2005, to open Kunming, Beijing and Xiamen

(5) On 1/1/2006, to open Shantou, Ningbo, Shenyang, Xi'an;

(6) And on 1/1/2007 all geographical restrictions will cancelled.

At the same time, since January 1, 2002 restrictions on operation in different locations have already been relaxed. Foreign banks, which have been approved to operate renminbi business in one specific city, in principle are permitted to provide services to customers of other cities open for renminbi business.

Gradually, restrictions on target customers of renminbi business will be cancelled in stages:

(1) Within 2 years from access (1/1/2002) to permit foreign banks to provide renminbi services to Chinese enterprises;

(2) Within 5 years from access, to permit foreign banks to provide services to all Chinese customers (national treatment).

4. Outlets in the Same City

Foreign banks will be permitted to set up local outlets in the same city. The approving criteria will be the same as those for Chinese banks.

5. Car Loan Services

Since accession, foreign invested non-bank financial institutions are permitted to enter into the car loan market of China and develop their business. There are no restrictions on market entry and national treatment is granted.

6. Financial Leasing Business

Upon approval from the Central Bank, foreign invested financial leasing companies may, in accordance with the same conditions for Chinese financial leasing companies, provide financial leasing services.

Overview of the Chinese Banking System and its domestic participants as of December 2002

Banks in China traditionally met government policy goals by financing the operations of State Owned Enterprises (SOEs), regardless of their profitability or risk. While bank exposure to SOEs has tended to decline over time, SOEs still accounted for over one half of outstanding bank credit in 2000. Out of the more than 40,000 different financial institutions of all kind in China, the most exposed are the "Big Four" state commercial banks (SCBs), namely Bank of China (BoC), Industrial and Commercial Bank of China (I&CBoC), China Construction Bank (CCB) and Agricultural Bank of China (ABC), which accounted for 86% of the assets of the banking sector.

Exposure to poor-performing SOEs has had a major impact on bank performance. According to official estimates, even after a large amount of loans were taken off bank books, no performing loans (NPLs) at the end of 2001 were $213 billion, or about 25% of total loans. This figure could be much higher if fully adjusted to reflect international definitions for NPLs. For example, the Bank of China's 1999 NPLs were found to be 2.6 times as high using international criteria as they were using the traditional Chinese definitions.

Bank vulnerability is accentuated by pressures on NPLs to increase. SOEs cannot very easily reduce their costs (for example, due to impediments to laying off workers), which limits their competitiveness and profitability, as well as their ability to service their debts. At the same time, because of their continuing importance and the fact that they employ millions of workers, it is very difficult to cut off SOEs from financing. SCBs thus face pressures to roll over SOE loans, even when SOEs have defaulted on their debts, which reduce funding for more worthwhile investment projects.

Reforming the financial system

In what today may be seen as preparation to the above mentioned WTO calendar for foreign banks willing to operate in the country, since 1997 Chinese authorities have taken a number of steps to strengthen the domestic banking sector to ensure that the financial sector will be able to support continued rapid rates of growth and to be able to compete with foreign financial institutions:

- **Strengthening bank balance sheets.** The government has borrowed heavily to recapitalize banks and take NPLs off their books. In 1998, it issued $32 billion in bonds to recapitalize the banking sector. In 1999-2000, bonds were issued by four asset management companies (one for each SCB) to absorb approximately $170 billion of bad loans. Chinese commercial banks are now adopting balance sheet criteria that reflect international practices; for example, as recommended under the 1988 Basle Accord, risk-based capital ratios of 8% are being maintained, although there is concern among some analysts that the Basle criteria understate the riskiness of assets held. Loan-loss provisions are now to reflect asset quality, and since the beginning of 2001, they are gradually reaching levels of 100% compared to 1% of loan balances previously. Financial statement definitions are also gradually being brought in line with international standards.

- Using commercial lending criteria. According to legislation and rules adopted in the mid-1990s, banks now must base lending on commercial criteria. Policy banks also have been established to free SCBs from lending to SOEs to meet government goals. Starting in 2000, credit to SOEs with overdue bank loans was cut off in several provinces; At present, this policy is being adopted gradually throughout China. To reduce risk exposure, loans must be made against collateral, banks must assess borrower creditworthiness, and loans to a single borrower must not exceed 10% of bank capital. To shield banks from political pressure, individuals and nonbank organizations may not interfere in bank operations. Commercial banks may not give unsecured loans to related parties or provide secured loans on preferential terms.

- Strengthening SOE finances and management. To prevent rising NPLs, the government is restructuring SOEs. Large SOEs are encouraged to adopt commercial practices, while small ones are being privatized. As part of this process, nearly 26 million workers were separated from SOEs in 1998-2001 (17 million were rehired, and 3 million retired). SOEs also must limit spending and no longer can assume that banks will automatically provide financing. According to a senior government official quoted in the China Daily Newspaper, nearly $10 billion will be spent in 2002 to close or merge unprofitable SOEs. In 2001, 460 SOEs were shut down, and $6 billion in NPLs were written off.

- Improving governance. More Chinese firms and banks are listing their shares, exposing them to market discipline. The top 100 firms listed in China's stock exchanges have some state ownership. In addition to the "Big Four Banks" (non listed) at present China has 10 nationwide joint stock banks but only four are listed – China Merchants Bank, Pudong Development Bank, Shenzhen Development Bank, and Minsheng Bank-. Recent press reports indicate that after the successful Initial Public Offering (IPO) launched in July by the Bank of China-Hong Kong (BoCHK) in the international market, its parent Company Bank of China-Beijing (BoC) as well as China's largest SCB, The Industrial and Commercial Bank of China (I&CBoC), may follow in the future. Also, early this year The Bank of Shanghai welcomed three international shareholders, including the global banking giant Hong Kong and Shanghai Banking Corporation (HSBC) and the International Finance Corporation (IFC) under the World Bank, which hold 8 percent and 7 percent respectively of the Shanghai Bank's shares. In a recent development, an Australian bank has established a joint-venture with CCB, the largest provider of private housing loans in the country to process mortgages. Banks also are required to introduce governing boards and are to be audited by an approved accounting firm.

Overview of the Chinese Banking System and its domestic and foreign participants as of December 2002

However, from a European point of view and taking into account our own recent history, China's WTO agreement to progressively open up its banking sector is unlikely to lead to explosive growth by foreign banks. The branch capital requirements which remain much higher that in the Single European Market and tough prudential controls over opening new branches would also limit foreign bank's expansion. At the same time the prospect of foreign banks gaining full access to the domestic market by 2007 will push Chinese domestic banks into streamlining and sharpening their operations, in order to become more competitive, over the next few years.

The size of the Chinese market makes it one of the most difficult in the world. At the moment the foreign bank with the biggest presence in China - HSBC - has just 9 branches, compared to over 30,000 for the Industrial & Commercial bank of China, China's largest domestic bank. It will take many years to build a presence in a country the size of China. Alliances and joint ventures will therefore be a likely route for many foreign banks, but these will need to be carefully chosen and may require significant levels of investment.

The Chinese government and the regulators are considering selling minority stakes in the domestic sector to foreign banks, so as to speed up the local bank reform process. However, despite the possible advantages of such alliances, concerns over the high entry price and the unknown extent of structural problems, such as over staffing and high non-performance loans (NPLs), may cause many foreign banks to adopt a wait and see approach. These banks will either hope to get better deals in the future or will set up their own operations, especially for corporate banking business.

It is the big foreign banks with a presence in Hong Kong that have been best positioned to start making inroads in the Chinese market - four of the largest foreign banks in China *(HSBC, Standard Chartered, Citibank and Bank of East Asia)* also happen to be four of the top five banking groups in Hong Kong. One reason why they are so strong in Hong Kong may be the fact that HSBC, Citibank and Standard Chartered bank were all present in China before the establishment of the PRC in 1949.

These banks have had the advantage of extensive contacts in China, a pool of managers who were able to transfer to their China operations and a deep understanding of the Chinese culture and market. Cultural issues and understanding of the corporate and private customer base is always a key factor in entering a foreign market. Other foreign banks who want to close the distance on these early leaders, in the race to build a franchise in China, will have to make a concerted effort over the medium to long term to build market share, always an expensive proposal.

From the perspective of the Chinese banks while they have a five year 'grace period' to gear up to meet full outside competition, decisive measures will need to be taken very quickly if they are to protect their market share over the longer term. Failure to improve services to retail customers by 2007, when foreign banks will be able to take local currency deposits from PRC individuals, could see the loss of many of the higher value accounts to foreign banks. This loss of the most profitable segment of their deposit base could prove extremely damaging to local banks. More sophisticated customer relationship management tools are therefore needed to identify and then improve services to these higher value customers.

Operational and risk management systems also need to be improved to better manage risk, improve profitability and to meet the capital adequacy requirements of the 1997 Basel accord, due to be introduced in 2006. Over time, Chinese banks also need to build stronger ties with banks and corporations around the world to prevent their large corporate clients going elsewhere, as they expand their operations overseas, as well as to protect themselves from a likely brain drain of staff to foreign competition.

Furthermore, domestic banks will need to adopt a more commercial approach to loss-generating clients, projects and business units. They must also cut their costs, dealing with both surplus branches and headcount, and develop better products and services for both corporate and private customers. Due to their low capital adequacy ratios, Chinese banks also may need to turn to the capital markets as alternative sources of finance and is likely to see a large number of banks seeking Initial Public Offerings (IPOs) to finance their restructuring plans over the next few years.

Conclusion

For all banks in China, the challenge is very much on. Compete at an international level, offer a more sophisticated range of products at a higher level of service, or watch some of your more profitable business move to another banks, be they foreign or local. I believe that is fair to conclude that China's recent accession to the WTO will create opportunities for foreign and domestic banks into the country booming market for retail financial services. However, it will be China's most profitable banking costumers and its demands what truly will redefine the competitive landscape of this industry. Those changing consumer preferences and the ability of local and foreign banks to adapt may have a more immediate impact that the WTO-mandate regulatory reforms.

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Sources: Banco Sabadell S.A., McKinsey, The People's Central Bank of China, The World Bank, KPMG, China Daily, Dai Xianglong, Nicholas Hardy, Fortune 500.