



Study on the Future Opportunities and Challenges of EU-China Trade and Investment Relations

Study 7: Financial Services

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EXECUTIVE SUMMARY

The **banking sector** in China is comprised of around 30,000 financial institutions with over 2.8 million employees in more than 500,000 banking units and, by strictly physical measures, has to be considered as one of the world's largest financial sectors. However, when comparing total banking sector assets (€2,801 billion) with EU banking sector assets (€29,010bn) or the US (€7,580bn) this gives a more sobering perspective. Still, the Chinese banking sector by assets is considerably larger than that of the whole of ASEAN put together (€1,884 billion).

The Chinese **insurance sector**, comprised of about 80 institutions, is small but developing quickly. An annual growth rate, at around 12% as measured by premiums, shows that this sector will become a significant market within the next few years - if regulation allows for it. China has adopted a protective regulatory regime in insurance, under which limits are placed on product and price competition. Strategically, the China Insurance Regulatory Commission (CIRC) aims to nurture the development of an insurance sector that is much stronger financially and more competitive domestically and internationally than at present. The CIRC views the proper role of foreign insurance companies as that of assisting in this development.

Mostly due to regulatory obstacles, foreign banks have a limited market share (less than 2%) in the Chinese banking sector. Only a few foreign banks have established sizeable stand-alone presences in China or taken significant minority stakes in local lenders. The strong growth of the financial sector (estimated at 10% per annum until 2010) and the increasing financing needs of the growing economy, means foreign investors look to increase business volumes in the individual consumer business (up to 20% growth in consumer loan business; 50% in credit card business), corporate business (15% in standard lending transactions, securitisation, etc.) and, with increased trade activity of their home country customers, growing trade finance business. Most foreign banks have already realised substantial returns within their first years of operation, cumulatively reaching to \$991 million.

Due to the need of the former SOE-based social security system to be substituted by private social security, foreign institutions see future opportunities in the Chinese insurance sector, and hope to raise their market share from their current 2% to 10%, with growth mainly coming from the life insurance sector. The market proportions of life and non-life have changed, but at the same time, both markets have grown rapidly. Between 1999 and 2004, the life insurance sector grew from \$10.7 billion to \$38.8 billion annual premium income while the non-life sector grew from \$6.3 billion to \$13.2 billion.

Obstacles to Trade and Investment

Banking Sector

| Major WTO Commitments | Remaining Practical Restrictions |
|--|--|
| Establishment of Subsidiaries & Branches (2002) | <ul style="list-style-type: none"> - Branches are treated as separate legal entities - Limited RMB borrowing from CN banks-Liquidity requirements - Consecutive branch opening with only 1 per year - High performance requirements for foreign institutions - Foreign shareholding in CN banks restricted |
| Engagement in RMB business in China - Corporate banking (Dec 2002) - Retail banking (Dec 2006) - No geographic restrictions (Dec 2006) | <ul style="list-style-type: none"> - High performance requirements for foreign institutions - Limited refinancing possibilities - Limited access to deposits (and refinancing) - Difficult access to SOE loan clients - To participate in retail RMB business and bank card business foreign banks have to incorporate subsidiaries |
| Engagement in foreign currency business (Dec 2001) | <ul style="list-style-type: none"> - CN companies can open only one account for currency loans, in city of location - Trade finance facilities granted by foreign banks are subject to tedious extra registration as "foreign debt of China" |
| Lifting of Non-Prudential Regulation (Dec 2006) | <ul style="list-style-type: none"> - Commercial Land Ownership restricted to 40 yrs |

Insurance Sector

| Major WTO Commitments | Remaining Practical Restrictions |
|---|--|
| Non-Life Insurance Presence - Foreign equity in JVs up to 51% (Dec 2001) - Wholly foreign-owned subsidiaries (Dec 2003) | - Foreign insurers need 30 years of business experience abroad - 2 yrs representative presence in China - total assets of min. \$5 billion |
| Life Insurance Presence - Max equity in JV of 50% (Dec 2001) - Max investment in Chin. Life Insurers 20% (1 investor) and 25% (all foreign investors) (since Dec 2001) | - Insurance companies may either supply life or non-life insurance, not both - Limited possibility to form holding with life and non-life company, due to life insurance restrictions |
| Non-Life Insurance Business - Full range permitted in principle (Dec 2003) | - "Statutory" (compulsory) third party motor liability insurance exclusion implies exclusion from first party motor insurance (sold together) - Motor insurance is about 68% of total non-life market |
| Life-Insurance Business - Geographical restrictions abolished (Dec 2004) | - No obvious additional restrictions, but foreign companies can only operate as JVs (max 50% equity) or minority shareholders in Chinese companies |

Quantitative Impact Market Access Obstacles

- In the retail RMB deposit business, European banks could face a progressive loss in potential business volume (on average about 70% of their potential business volume). This would, under the assumptions made in this paper, create progressive opportunity costs due to foregone business opportunities amounting to as much as 1.8 billion € by 2010.
- In the RMB lending business, this lost market share is estimated at ¼ in the first years and could amount up to 50% by 2010 or 1.2 billion € in opportunity costs for European banks.
- In foreign currency lending, costs to European banks could amount of up to 1/3 by 2010 of the "feasible" business volumes, or 175 million € in opportunity costs.
- Opportunity costs for European insurers of non-access to motor insurance in non-life insurance business could amount to 20

million € by 2010, and costs due to not allowing stand-alone life insurers could amount to 220 million € by 2010.

Policy Recommendations

- The European Commission should work towards a level playing field for financial institutions in the banking and insurance sectors.
- EU Joint Approach: Build platforms for joint representation of interests of EU financial institutions (not nation by nation). To improve leverage vis-à-vis the Chinese government, European financial institutions should approach issues with one voice.
- Increase the quantity of dialogue between industry practitioners and EU representatives in the formulation of policy issues.
- Discussions with the regulators in China should be aimed at the ministerial level to ensure greater effectiveness.

Trade Policy Goals

| Banking Sector | Insurance Sector |
|---|--|
| - Easier branch network licensing and implementation - Easier regulatory treatment of foreign bank branches (capital and liquidity requirements) - Non-discriminatory access to foreign trade finance also with Chinese clients - Possibility to acquire majority stakes Chinese banks | - Possibility to acquire majority stakes in Chinese life insurers - Easier and more transparent licensing process allowing nation-wide geographical expansion for foreign invested insurers - Possibility to operate stand-alone for EU life insurers - Opening of "statutory business" in non-life insurance |

Recommendations for Competitiveness

Banking sector

Organic growth is likely to be an attractive option for foreign banks although the creation of wholly owned branch networks will be severely restricted by the new regulatory system. Any foreign bank wishing to compete for the larger market segments will therefore have to a more or lesser extent partner with Chinese institutions. In this, the critical question for many foreign banks in the shorter term will be whether their investors' rights will be protected while in the longer term whether at some point in the future a more substantial (even controlling) stake will become an option. Compared to the big four banks, the smaller commercial banks have better asset quality, with relevant networks in major coastal cities (location of industrial and commercial hubs) and show good return prospects. In addition, in these smaller commercial banks the possibility of some form of management, control and protection of investors' rights would seem greater. Immediate areas for cooperation could include syndicated loans, loan swaps, cooperation in trade finance, factoring and forfeiting (knowledge on EU side), and cooperation in RMB business (knowledge on Chinese side).

Insurance sector

In the non-life insurance sector, restrictions have provided foreign firms with little opportunity to adopt distinct market or product strategies. This also accounts for pricing strategies which have played a minor role so far due to regulations limiting price differentiation. Nonetheless, foreign insurers will have to establish a niche strategy under given conditions and develop a high level of product innovation

Differentiation in the life insurance sector is similarly constrained due to restrictions. Distribution of both Chinese and foreign insurance companies appear have so far mainly focused on sales through agents and sales-staff, targeting the higher end of the market. However, targeting different segments other than the high-income level segment could also be potentially lucrative, but would require changes in distribution strategy, i.e. less individual agent based strategy in favour of cheaper distribution models. Some European insurers are already doing this through their partnership with local financial institutions, taking advantage of their substantial branch networks. Product marketing will also have to be fine tuned, where pension and health-related products will be a major area of new opportunities.

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ABBREVIATIONS

| | |
|-------|--|
| AMC | Asset Management Company |
| ASEAN | Association of Southeast Asian Nations |
| CBRC | China Banking Regulatory Commission |
| CIRC | China Insurance Regulatory Commission |
| FDI | Foreign Direct Investment |
| FX | Foreign Exchange |
| GATS | General Agreement on Trade in Services |
| GATT | General Agreements on Tariffs and Trade |
| GDP | Gross Domestic Product |
| ITICS | International Trust and Investment Corporations |
| JV | Joint Venture |
| MFN | Most Favoured Nation |
| NPL | Non-Performing Loan |
| PBC | People's Bank of China |
| RMB | Renminbi (CNY) |
| RMBS | Residential Mortgage Backed Securities |
| SASAC | State Assets Supervision and Administration Commission |
| SCB | State-owned Commercial Bank |
| SOE | State Owned Enterprise |
| SME | Small and medium-sized enterprise |
| SWOT | Strengths, Weaknesses, Opportunities, Threats (Analysis) |
| WFOE | Wholly Foreign Owned Enterprise |
| WTO | World Trade Organisation |

1. INTRODUCTION

China commenced its gradual transition from a planned economy to a more market-based and outward-looking economy in 1978. Negotiations on its status in the GATT began in 1986 and China finally became a member of the WTO in 2001. The ensuing commitments provided a catalyst for further far-reaching economic reforms, including the ongoing reorganisation of state-owned enterprises, the development of the banking system and measures to develop a fully functional capital market able to meet the financial needs of the emerging dynamic private sector (e.g. SMEs) and that of the government. Reforms have allowed for a gradual reduction of the dominant role of state-owned enterprises (SOEs) and the closure of a large number of effectively bankrupt enterprises. With this, the dominant role of SOEs as (bad) loan clients will be reduced, thereby mitigating one of the main problems in state-owned banks, i.e. the volume of non-performing loans (NPLs), which continue to place a substantial burden on the balance sheets of at least half of the banks in the financial system. However, at the same time, with the gradual reduction of the role of SOEs in the economy and the laying off of 16 million workers, the need becomes urgent to develop a functioning labour market and to establish a social safety net that would replace the support system previously provided. This reflects the interconnectedness of reforming policies. If severe social pressures are to be contained and social security strengthened, the fiscal implications of the state budget will be high and, while certainly involving the state owned banking sector, will first and foremost require the development of the insurance sector. This wholesale impact on the financial sector will put further pressure on establishing a smoothly functioning capital market.

China's economic reforms, although gradual, have increased the market orientation of its economy, making it one of the fastest growing in the world. Proposals for the 11th Five Year Programme for National Economic and Social Development, approved in October 2005, aim to double GDP per capita by 2010 relative to 2000, while also tackling the disparities in income distribution, energy efficiency, the environment, and the need to develop a "harmonious society". Given the pace of economic growth and reform in the past two decades, there is no convincing rationale that doubts China's ability to double its GDP per capita by 2010 providing the reform process retains its momentum. Indeed, there has been a gradual shift in economic policy away from central planning and direct intervention, moving towards a

systematic provision of "guidance" to the economy. Such "guidance" was provided in the financial sector in 2004 for example, when financial institutions were advised to stop the provision of financing to certain types of projects. Although credit policies have been relaxed over the years, cooling the overheating economy required that capital expenditure needed to be curbed. This guidance was also accompanied by a number of other measures affecting the commercial banking sector. These included the withdrawal of liquidity by the People's Bank of China (the central bank), the raising of the deposit rate by 0.5% points, the removal of the floor on Renminbi (RMB) deposit rates and the removal of the cap on RMB lending rates.

Many of the financial sector reforms were and continue to be aimed at moving further away from the historic legacies of the state-controlled credit system and moving the orientation of financial institutions towards one that is governed by commercial principles. To bring in strategic investors steps are being taken in the recapitalisation¹ of state owned banks including changes in legal structure and reforms aimed at improving corporate governance and risk management. Gradually, impediments to financial sector market access are being removed, but much slower than in other sectors of the economy and other major developing (and developed) countries. This is despite an increasing urgency for financial sector reform. Chinese banks will need to be prepared to face intense competition when, under WTO accession commitments, the financial sector will be fully opened up to foreign banks in 2007.

Similarly, the insurance sector, where reforms have been slower still, the opportunities for foreign competitors are huge, due to the large and underdeveloped market situation. However, whether these opportunities can be maximised economically and be implemented operationally is something which must be evaluated critically.

2. COMPETITIVE ENVIRONMENT IN CHINA – LEGAL AND ECONOMIC CONTEXT

2.1 Drivers for Direct Investment by Foreign Financial Institutions in China

Due to the importance of offering financial services at the local level, the dominant drivers for multinational banks and insurance companies to enter global financial markets such as China can be determined by three interrelated factors: location, ownership and internalisation advantages.²

Table 1: WTO Accession - Steps towards Market Liberalisation

| | |
|----------------|--|
| By 2002 | Permission for foreign financial institutions to establish a subsidiary or branch |
| By 2004 | Permission to apply for engagement in local currency business in China (under observation of the geographic and client restrictions indicated below) |
| By 2006 | -No geographic restrictions for conduction foreign currency business with regard to commercial presence in China -Foreign currency services can be supplied to all types of clients (by 2006) -Abolishment of any existing non-prudential measures restricting ownership, operation, and juridical form of foreign financial institutions, including internal branching and licences |

Location advantages are specific attractive advantages found in the host country. Location advantages inducing multinationals to enter a host country may include adequate government regulations, such as a favourable degree of regulation on banking and insurance activities on the one hand, and a liberal but sufficiently protecting institutional framework on the other hand. As shall be seen later on, these advantages cannot be considered to be provided by the Chinese market. However, the sheer size and potential of the Chinese market is a locational advantage which few, if any, foreign multinationals are able to ignore.

Ownership advantages are the specific advantages of multinationals that make them competitive in their home markets. As a basic assumption, these advantages are transferable to foreign markets to offset the additional costs associated with doing business abroad. Due to the high financial requirements of operating in China (as set by Chinese regulations), the size and capital base of foreign financial institutions is of particular importance, since it has a significant impact on their financial capacity to enter the Chinese market. Furthermore, full leverage of ownership advantages of foreign banks operating in China is often constrained by the difficulties in obtaining regulatory permission to offer specialised and differentiated financial products. However, foreign banks do have other ownership advantages such as better credit risk management, access to established multinational customer networks and technology which they would like to exploit in the Chinese market.

Internalisation advantages: The greater the net benefits of internalising cross-border intermediate product markets and the greater the possibility to extend synergies with existing markets and products, the more likely multinationals will be willing to conduct business in foreign markets rather than license the right to foreign firms. The expansion of multinational banks and insurance companies' in international markets as opposed to doing business at

arm's length is premised on internalisation advantages. This is due to the remaining difficulties associated with finding adequate market information, commercial links and issue data without physical presence in foreign markets. Bank and insurance services are to a large extent non-tradable. Thus ownership or FDI regulation for foreign banks and insurance companies is of major importance, and restrictions on entry vehicles might prevent some business transactions from taking place.

From the above section, it is clear that with the further liberalisation of the Chinese market (particularly following the implementation of WTO obligations post-2007) foreign financial institutions will increasingly invest in China as the drivers for foreign direct investment become increasingly favourable. However, to what extent this will be the case will be discussed below.

2.2 China's WTO Commitments

The gradual liberalisation of the banking sector for foreign financial institutions as a result of China's commitments under the WTO and GATS (General Agreement on Trade in Services) schedules³ is summarised in **Table 1**). China liberalised its services sector basically in line with its GATS schedule⁴, major developments include:

- *Conditional*⁵ permission for foreign financial institutions to establish a subsidiary or branch.
- *Conditional*⁶ permission to apply for engaging in local currency business.
- Gradual removal of geographic restrictions⁷ (2006) with 25 cities open to foreign banks offering local currency products; no geographic restrictions for supplying financial products in foreign currency following China's WTO accession.

The clients that local currency services could be supplied to, however, remain restricted. The local currency market with Chinese enterprises was opened for foreign banks only in 2003 and for local currency business with private individuals the market will be

opened at the end of 2006, in accordance with WTO commitments.

Cross-border supply of banking and other financial services (excluding insurance) has been left "unbound", i.e. not covered by WTO commitments, except for the provision and transfer of financial information, financial data processing and related software by suppliers of other financial services and advisory, intermediary and other auxiliary financial services.

With regard to the horizontal issues some more relevant restrictions for financial institutions are noted:

- Commercial presence (mode 3)⁸ minimum equity requirements on market access for foreign equity held in a joint venture (at least 25% of the registered capital of the joint venture).
- The establishment of branches by foreign enterprises is "unbound" unless otherwise indicated in the specific commitments; the establishment of representative offices is permitted in China, but these may not engage in any profit-making activities, except as indicated in China's specific commitments.
- The ownership of land by enterprises and individuals is subject to the following limitations:
 - 70 years for residential purposes;
 - 50 years for industrial, education, science, culture, public health, physical education;
 - "Comprehensive utilisation" (multi-utilisation of land, according to the authorities);
 - Other purposes and 40 years for commercial, tourism, and recreational purposes.

With regard to the **insurance sector**, China made commitments under the GATS related to life, health and pension/annuities insurance, non-life insurance, reinsurance and auxiliary services with the following major results:

- Market access through cross-border supply (mode 1) remains to a large degree "unbound". Commitments in mode 1 were made only on reinsurance, international marine, aviation, transport insurance, and brokerage for large-scale commercial risks.
- Market access through consumption abroad is unlimited, except for brokerage, which is "unbound". There are no mode 1 and 2 limitations on national treatment.
- Market access through commercial presence (mode 3):

- Foreign non-life insurers were initially to be permitted to establish branches and joint ventures with a maximum of 51% foreign ownership; foreign non-life insurance providers are now (since December 2003) permitted to establish wholly owned subsidiaries as scheduled.

- Foreign life insurers are permitted to establish joint ventures, but their ownership is restricted to 50% equity participation. As for investing into existing Chinese life insurance companies, the "Rules on Administration of Insurance Companies" restrict a single foreign shareholding to 20% and all foreign shareholdings to 25%.

- For brokerage services, foreign equity of up to 50% is permitted in joint ventures in large-scale commercial risk insurance and reinsurance, international marine, air transport, and transport insurance and reinsurance; this was raised to 51% in 2004, and will, under current plans, be removed by end 2006. Other brokerage services remain "unbound".
- Geographical restrictions on foreign life and non-life insurers and brokers have been gradually removed as scheduled, ending in 2004.

Restrictions remain on the business scope of foreign insurance providers. Upon accession, foreign non-life insurers were to be permitted to provide "master policy" insurance, insurance of large-scale commercial risks without geographical restriction, insurance for enterprises based outside China, property insurance, related liability insurance, and credit insurance for foreign-invested enterprises in China. They were to be permitted to provide the full range of non-life insurance services to foreign and domestic clients within two years of accession (2003); and, according to the authorities, this liberalisation took place as scheduled. Insurance companies may also provide individual but not group insurance to foreigners and Chinese nationals. By December 2004, foreign insurers were, as scheduled, allowed to provide health insurance, group insurance, and pension/annuities insurance to foreigners and Chinese nationals. Reinsurance services for life and non-life insurance were open to foreign providers upon accession through branches, joint ventures or wholly foreign-owned subsidiaries without any geographical or quantitative limitations on the number of licences issued. Upon accession licences for insurance services were to be issued without

an economic needs test or quantitative limits subject to certain conditions.⁹

With regard to national treatment, there are no limitations for mode 3 except that foreign insurance institutions may not engage in statutory insurance business; and as of the date of China's accession, 20% of all primary risk insurance for non-life, personal accident, and health insurance business must be ceded to an appointed Chinese reinsurance company. The percentage to be deposited with the appointed Chinese company is to decline gradually (to 15%, 10%, and 5% annually within three years after accession); there will no longer be such a requirement four years after China's accession to the WTO (December 2005) and according to the authorities, this requirement was removed on schedule. National treatment with regard to mode 4 is "unbound" except as indicated in China's horizontal commitments.

3. REMAINING MARKET ACCESS RESTRICTIONS FOR FOREIGN FINANCIAL INSTITUTIONS

Table 2: Overview of Market Access Obstacles

| Section | Topic |
|---------|---|
| 3.1 | Restrictions Foreign Participation in the Chinese Banking Sector |
| 3.2 | Restrictions Foreign Participation in the Chinese Insurance Sector |
| 3.3 | Government Intervention , Limited Market Incentives and the Role of SOEs |
| 3.4 | Market Access Obstacles: Survey Results |
| 3.5 | Economic Costs of restricted Market Entry |

3.1 Restrictions Foreign Participation in the Chinese Banking Sector

Although foreign banks are allowed to open branches, regulatory treatment remains discriminatory. Unlike in the international context, all branches of foreign banks in China are treated as if they were separate legal entities, and not as part of a consolidated network. This system increases the associated costs of opening more branches in China and is costly in terms of capital requirements for each branch, complexity of balance sheets and general management. Some of the major remaining restrictions include:

3.1.1 Prudential Requirements

Excessive capital requirements of between RMB 100 million (EUR 12.3 million) and RMB 600 million (EUR 73.8 million) are placed on each branch to be licensed. This differs significantly with the EUR 5 million capital requirement for a bank to operate in Europe.

These capital requirements are even higher than in the era prior to China's accession to the WTO. The CBRC justifies this as "prudential regulation", but it is seen by some as rather an expensive method of slowing down the opening of branches.¹⁰

Unconsolidated calculation of capital adequacy ratio:

Foreign banks have to hold a ratio of capital to risk-weighted assets of minimum 8%, both for RMB and foreign currency loans, thus in principle in accordance with international standards (Basel I). But again this ratio must be calculated for branches separately and fulfilled individually by each branch; therefore, foreign banks with a branch network will in reality have to have a much higher minimum capital adequacy ratio than 8%, since some branches will always have higher ratios than the 8% minimum. In contrast thereto, Chinese banks on average have a capital adequacy well below 8%. By end 2004, only 30 Chinese banks representing 48% of total banking sector assets met the 8% requirement, and the total shortfall of Chinese banks' capital was estimated at around EUR 100 billion.

Excessive Liquidity Ratios: The foreign currency lending operations of foreign banks are also indirectly restricted via excessive liquidity ratios. Foreign banks have to hold at least a quota of 25% of their foreign currency assets (e.g. loans) in liquid foreign currency assets (e.g. cash, or placements with well-rated institutions). But placements to their own mother companies are netted with borrowings from their mother company. Such borrowings are the main source of foreign currency funding for foreign banks in China since no significant Chinese foreign currency deposits are available. Thus, a large part of the placements of foreign banks don't count into the liquidity ratio. Having to fulfil the liquidity ratio, limits the possibilities of foreign currency lending in China. An improvement would be to count their foreign currency placements "un-netted" into the liquidity ratio.

3.1.2 Discrimination in RMB Business

In principle, foreign banks are now allowed to engage in RMB lending. But unlike Chinese banks, they may not use foreign currency deposits of the borrower as security/collateral for such RMB loans. Newly set-up foreign banks, or even newly set-up branches of foreign banks, can only apply for a RMB business license after three years.

RMB funding restrictions: Due to their smaller branch networks, foreign banks have a natural funding disadvantage since they find it much more difficult to tap the RMB

deposits of the population. Therefore, they must try to fund themselves through wholesale operations, i.e. by borrowing in RMB from Chinese banks who hold huge deposits (interbank market). A planned new regulation to be phased in for foreign banks over the next five years however would restrict such interbank borrowing to a maximum of 40% of the respective foreign bank's branch liabilities, and would limit the maximum tenure of such interbank borrowing to 3 years. Together with the discrimination in expanding the branch network, these restrictions could, in practical terms render the full RMB business licenses useless due to lacking RMB refinancing possibilities. This holds true in particular in the field of consumer finance, where consumer loans are usually larger than consumer deposits, and banks are thus reliant on borrowing from other banking institutions.

Limitation to open one branch per year:

Besides the economic disincentives due to high capital requirements described above, the rule that foreign banks may only open one new branch per year is another way of limiting the branch network expansion of foreign banks in China. This is of particular importance when taking into account that a "competitive" nationwide network would consist of around 25,000 branches, similar to the amount a typical large Chinese SOB has.

3.1.3 Discrimination in Foreign Currency Lending Operations

Although foreign banks may in principle lend in foreign currency to every Chinese company, the Chinese company requires a state permission to open an account and receive a loan from a bank in foreign currency. Thus, the state remains in control to decide which Chinese companies foreign banks can lend to, which is strictly against the spirit of the WTO agreement. Furthermore, companies are usually allowed to open just one such foreign currency (loan) account, and only in the city of their operation. Therefore, foreign banks with smaller branch networks than their Chinese competitors are hindered in their lending to Chinese companies in foreign currency. More direct discrimination also exists in that transferring shareholder loans from abroad to Sino-Foreign Joint Ventures is a business field restricted to Chinese banks.

Discrimination in Trade Finance with Chinese Companies: Within the only partly liberalised foreign currency regime in China, all foreign currency trade finance facilities taken by Chinese trading companies are subject to state approval. However, if foreign banks want to issue such foreign exchange trade finance facilities the approval process is more tedious, since every such facility is

individually considered as "foreign debt of China" and therefore needs specific approval.

A new regulation is planned, however, to consolidate the "foreign debt of China" definition within the balance sheet of foreign banks. If such new regulations are implemented, foreign banks could in principle issue foreign exchange trade finance facilities according to the same approval processes as Chinese banks.

3.1.4 Consequences for Patterns Foreign Direct Investment

As shown from these discriminatory restrictions, the advantages depicted above resulting from location, ownership and internalisation are still severely limited for foreign banks operating in China:

Location advantages are mainly diminished by the fact that expansion of the branch network is limited (only 1 branch per year) and by "prudential regulations", rendering businesses very costly for foreign banks.

The "branch by branch" regulatory treatment furthermore reduces ownership advantages, since available capital and liquidity of a foreign bank operating in China cannot be counted and employed efficiently on a consolidated basis. Other practical restrictions reducing the economic value of ownership advantages remain. Despite ownership of banking assets, some important markets can hardly be accessed by foreign institutions. These include the RMB lending market serviced by many Chinese banks at "prices below costs", (due to risks not being properly accounted for) and the foreign trade finance market with the growing number of Chinese exporters (due to regulations regarding foreign exchange transactions in general). Another restriction to enjoying ownership advantages for foreign banks in China are limits on cross-selling and synergetic use of funds, for instance the impossibility of using FX deposits as collateral for RMB loans, or the netting of foreign currency placements with foreign currency borrowings when calculating the liquidity requirements.

Internalisation advantages: Linking home markets with the Chinese market due to the largely "non-tradable" nature of financial products (i.e. internalising of operations) is realised by following home market customers operating in China, e.g. through trade finance or lending to their Chinese subsidiaries. No major restrictions or practical limitations are found here, and these internalisation advantages were indeed a major reason for foreign banks entering China. However on a

larger scale, since banking services are largely non-tradable and thus cannot, to put it abstractly, be “produced cheaply in China and then be re-exported”, foreign banks ultimately require local Chinese clients in order to be profitable. Restrictions in this area therefore have an indirect impact on the extent to which internalisation advantages can be realised.

3.2 Restrictions Foreign Participation in the Chinese Insurance Sector

Setting-up representative Offices: Until recently, foreign insurance companies had to have a successful business experience of at least 3 years abroad before being allowed to open a representative office in China. Recently, this period has been prolonged to 20 and now to 30 years. Thus, younger international insurance companies will be barred from the Chinese market through this officially “prudential” regulation.

Multimode operations: Under Chinese Insurance Law¹¹, insurance companies may either provide non-life or life insurance, but may not work in both business fields under the same legal entity. This regulation fits well with the specialised Chinese insurance companies, but restricts international insurance companies, who in their home market often provide both life and non-life products, from realising internalisation advantages.

Non-Life Insurance: A Foreign Insurance Company must apply to and maintain a representative office for 2 years before being allowed to open a branch office, which can then conduct insurance business. For motor insurance, being the most important segment of non-life insurance, additional restrictions remain. In particular, foreign insurers are not entitled to write policies for compulsory third party liabilities. Branches of foreign non-life insurance providers are licensed by the China Insurance Regulatory Commission (CIRC) “consecutively”, i.e. only one branch after the other”, whereas in practice Chinese insurance companies can obtain new licenses for several branches at the same time.

Life Insurance¹²: Foreign companies are only allowed to do business in joint ventures (JV) with Chinese companies, may not hold more than 50% of the share of the JV and must share the management of the JV company with their Chinese partner. Since 2005 they may also write group policies, health or pension policies, but given the strong networks between Chinese insurers and corporations, this market will remain difficult to access. Alternatively, foreign companies can invest in Chinese insurers, but

may not hold more than 20% of the share capital (and a maximum of 25% cumulated investment by foreign companies in a Chinese company).

Besides these remaining legal restrictions, the developing economic environment also poses some major challenges to the ability to compete of foreign insurance institutions. Thus, in the Chinese insurance market major impediments remain which prevent foreign suppliers from fully realising their location, ownership and internalisation advantages. Similar to the banking sector, location advantages are partly withheld from foreign non-life insurers, since branches are usually licensed more slowly than for Chinese counterparts. Ownership advantages are largely withheld from foreign life-insurers, since they are so far not entitled to operate independently. In addition, they are not usually able to secure control rights in joint ventures or through their minority participations in Chinese insurance companies. But also in the non-life insurance sector, business advantages and opportunities are largely withheld from foreign providers since the most important areas (statutory business), in particular third party motor liability insurance, are not open to foreign participation. Again, similar to the banking sector, cross-border business, (and the resulting possibilities to realise internalisation advantages), are not directly restricted, but are however affected indirectly by unfavourable legislation.

3.3 Government Intervention, Limited Market Incentives and the Role of SOEs

3.3.1 Public Ownership and Control in the Financial Sector

Financial intermediation in China is still mainly done through a highly concentrated financial sector, where the largest four banks currently account for 54% of banking assets and six insurance companies for 85% of insurance premiums. These financial institutions are, in the majority of cases, fully owned by the state. Additionally, the state directly or indirectly controls 95% of the assets of most other players through shares held by local authorities and state-owned enterprises outside the banking sector. True private banks however, albeit officially qualified as such, do not exist in reality¹³. Foreign ownership is still extremely limited, despite a handful of high-profile investments¹⁴ such as by Citibank, HSBC or Deutsche Bank, and mostly only allows minimal management involvement or control.

Table 3: Regulation of Interest Rates from Commercial Banks

| Year | Loans (RMB) | Deposits (RMB) |
|---------------------|--|---|
| 1996 | All enterprises: 0.9 times to 1.1. Times the official benchmark rate | Deposit rate required to equal to the official benchmark rate |
| 1998 | Medium and large enterprises: 0.9 times to 1.1 times Small enterprise: 0.9 times to 1.2 times | no change no change |
| 1999 | large enterprises: 0.9 times to 1.1. times Small and mediuma enterprises: 0.9 to 1.3 times | no change |
| Jan-04 | All enterprises: 0.9 to 1.7 times | no change |
| Oct-04 | Upper limit removed Lower limit unchanged at 0.9 times | no change lower limit removed |
| Source: PBC and FSF | | |

In the last decade, China has implemented a number of measures to improve the performance of its state-owned commercial banks such as: introducing new legislation and accounting rules to improve financial transparency, founding Asset Management Companies (AMCs) to “outsource” NPLs¹⁵, and injected large amounts of capital into the major banks. Despite the steps taken by the government, the Chinese banking sector has not substantially changed its behaviour nor has it become truly commercially oriented. Recently, Ernst & Young (E&Y), an auditing and management consulting company, issued a report which estimated the total value of NPLs in the Chinese economy at 911 billion USD, and valued NPLs at the four large SCBs at 358 billion USD. These figures, which valued NPLs at around three times higher than official Chinese data, were harshly criticised by the authorities and E&Y consequently withdrew their report stating that it was “erroneous”. It is unclear, and the subject of much speculation whether E&Y really made factual errors or, as the auditors of one of the four SCBs, wants to preserve its business opportunities in China.

The capital markets also suffer from excessive state-involvement. Out of the 1,378 listed companies on China's two domestic stock exchanges (as of 2005), 71.6% are state-holding companies. Only 36% of all shares in listed companies are tradable, which means almost two thirds of the shares are not tradable and within these a further two-thirds are directly or indirectly owned by the state, which indicates a lack of distinction between the state's role as a shareholder and as a regulator and presents potential “conflicts of interests”. In essence, the capital markets cannot therefore be regarded as a significant alternative to bank financing for most Chinese enterprises, particular private ones that are often prevented from being listed.

3.3.2 Discretionary Intervention and Lack of Market Incentives

Instead of relying on market-based instruments of monetary policy, the authorities still rely on a large amount of “guidance”, tending to distort the financial system - notably the credit market. Monthly meetings between state representatives and commercial banks, urging them to avoid excessive credit expansion, are an inadequate tool and do not support allocation of credit to the most profitable investment. This type of government intervention will probably burden foreign competitors indirectly even after the opening of the markets by 2007. While the government is unlikely to influence foreign financial institutions directly, SOEs, who present a major potential client base, remain under the direct control of the state. Therefore when an SOE applies for a license when taking a loan, the state can decide which bank can lend to which SOE, and thus indirectly has the power to curb the lending business of foreign competitors. “Guidance” in interest rates¹⁶ prevails, notwithstanding liberalisation in 2004, where upper limits for lending rates and lower limits for deposit rates were removed, while lower limits in interest rates remained at 0.9 times the official benchmark rates (see **Table 3**). Differentiation of interest rates on new loans initially increased somewhat, but quickly became more uniform again during 2005. In practice, Chinese banks made little use of this new freedom in adequately pricing credit risk. Only among the group of regional banks and credit cooperatives, was interest liberalisation more widely used.

In an immature and high-risk market where on the lending side the majority of players do not raise interest rates, fully confident that the state will bail them out if necessary, there is little room for normal competitive behaviour. If foreign banks charged higher interest rates, they would probably lose market share and therefore foreign banks

have to try to tap market segments, which are not interesting for the majority of Chinese banks, notably the SME market. On the deposit side, the upper rates set by the People's Bank of China (PBC) remain binding. As a result, foreign banks, hampered already by their much smaller branch networks, cannot gain a competitive edge by offering higher deposit interest rates than Chinese banks in order to pull away deposits from them. The so-called "huge" market with regard to the Chinese "savings pool" therefore seems more than questionable in terms of practical accessibility.

3.3.3 The Problem of an Inefficient Banking System

The most directly observable shortcomings in the "competitive" environment, is exemplified by the fact that most banks in China are technically insolvent, as their nonperforming loans by far exceed their equity¹⁷. Nevertheless, this does not seem to pose an immediate threat to the survival capacity of the larger banks nor to the banking system's immediate stability. Due to the lack of viable alternative savings channels, and that customers feel secure in the knowledge that the state will intervene in case of any problems, a high savings rate equalling 40% of GDP prevails and banking institutions are highly liquid. This large retail deposit base of Chinese banks continues to expand as a result of a robust economy, lack of alternative, differentiated saving products and the limited scope to place deposits with foreign institutions. As a result, the big four SCBs still hold more than half of total banking sector deposits.

On the asset side, many Chinese banks don't recognise bad loans, because even if they are performing on a cash-flow basis they might not meet necessary technical criteria, such as with a loan whose interest is being paid by a business that isn't generating the cash needed to repay the principal. In China, banks often consider such a loan to be performing, though the principal is clearly at risk. If a bank doesn't recognise a loan as nonperforming, it won't take the appropriate charges on its books or reserves and reported profits will mislead regulators, investors and customers. Additionally with these loans, collaterals are sometimes more than questionable. It is not unusual for borrowers to have fictitious addresses, with no real property as collateral. Some mortgage holders have even received money for properties they didn't own.

Since a consistent loan classification system was introduced several years ago, progress has been made in the reporting of NPLs.

However, an adequate transparency and risk culture is still lacking. The quality of disclosure remains poor in other fields as well and the information risks remain high. Annual reports are usually not ready in time, contain limited information emphasising improvements made and targets met, while problems are glossed over and footnotes are sparse. Furthermore, a variety of techniques are employed to embellish profit figures. A typical way is to charge loan loss expenses directly to shareholders' equity rather than recognising them as expenses first, thus hiding the true nature of this type of losses. Since the nineties, many regulations have been initiated in this area, notably accounting policies. While in theory fairly consistent with the basic concepts of international accounting standards, the implementation and enforcement of these standards remains a problem. Domestic audit opinions are often inaccurate, while international auditors are scarce. Law enforcement is traditionally based on intermediation rather than recourse to the courts, and largely includes protection of local interests and government interference.¹⁸ Fundamentally, the problem lies in excessive state ownership. Although, Chinese banks are improving their corporate governance systems by listing abroad, the fundamental problems of state-ownership and excessive decentralisation remain. In the meantime, foreign competitors acting under accountable and transparent corporate governance systems are arguably at a competitive disadvantage in winning new customers.

3.3.4 Weaknesses and Vulnerability of SOE Clients

The government is aware that too rapid a change could mean the bankruptcy and closure of major Chinese banks. With this, credit supply to SOEs would be drastically reduced, leading to bankruptcies and larger scale layoffs putting pressure on social systems and the government. Interest coverage (the operating profit potentially available to cover interest expenses) in SOEs is as low as one-third of the ratio observed in major industrial countries. Firm-level data for listed enterprises suggest that Chinese enterprises cannot generate enough cash flow to pay interest on about 20 to 30% of their total debt. A moderate rise in interest rates or a moderate drop in sales could cause 40 to 60% of the debts of all firms to become unserviceable, a problem that banks will have to face.

Such stability risks based on the interdependence of Chinese banks and SOEs is deemed one of the main political reasons for restricting the market access for foreign banks. Rather than fostering the

setting-up of new foreign banks across China, thereby allowing for “uncontrolled competition”, the authorities are seemingly eager to find foreign minority investors for Chinese banks. These should bring in capital, share part of the risks (associated with NPLs, for example) and offer technology and management to improve the performance of China’s banks in the longer run. By entering into such ventures, foreign banks of course assume part of the balance sheet risks of Chinese banks, but as minority shareholders usually do not gain significant managerial control.

In effect, the largest part of China's domestic savings is still left in the hands of non performing banks which have lent mainly to SOEs (accounting for roughly half of outstanding bank credit) resulting in considerable over-investment in certain sectors with insufficient returns on capital. SOE’s are in this respect still subsidised by undertaking new investments despite returns falling short of the cost of capital. In contrast, the capital market and banking sector have played a more limited, albeit growing, role in financing private-sector businesses, especially SMEs, which account for around 60% of industrial output and 79% of newly created jobs, despite continued difficulties in obtaining financing.

For the transition from the old financing system, the fate of the remaining 170,000 SOEs will be crucial. Reforms of SOEs since the 1970s (incorporation under the company law, attempts at improving corporate governance, restructuring and even closure of the most inefficient SOEs) have been gradual, mainly due to their pervasive influence on large sections of the economy. As a result, the number of SOEs has been cut by almost 50% since the late 1990s, but according to estimations nearly half of the remaining SOEs are still unprofitable.

In that respect, the Chinese authorities face a dilemma between on the one hand liberalisation goals in the banking system, allowing for more efficiency, and even the closure of bankrupt institutions, and on the other hand, the preservation of funding sources for the SOE sector in order to retain economic and social stability. The gradual approach taken by the authorities of slowly hardening budget constraints for SOEs and step-by-step liberalisation of the financial sector, thus for the time being seems to be without a convincing alternative. European and other foreign banks, it seems, could directly support these efforts of gradual restructuring with their experience in debt-equity-swaps (with regard to SOEs), securitisation and trading of problematic loan

portfolios (of SOEs) or, as is already happening and welcomed by the authorities, by taking over stakes in the Chinese banking sector currently held by the government.

3.4 Market Access Obstacles Survey Results¹⁹

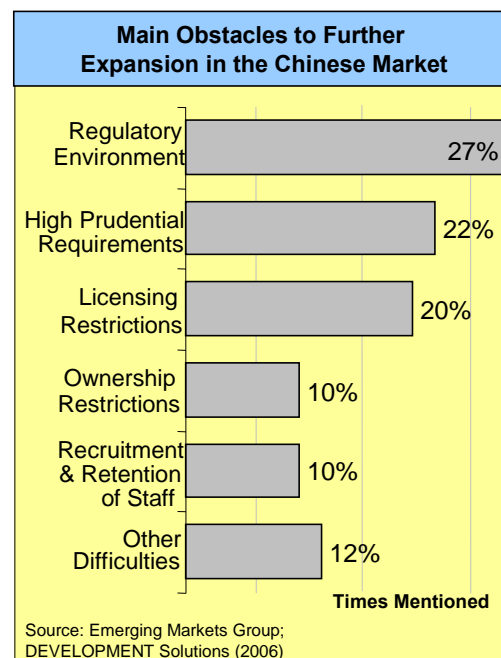


Figure 1: Recurrence of Market Obstacles Cited in Survey

For this study an in-depth survey was conducted of over 20 European financial institutions operating in Beijing and Shanghai (see **Figure 1**). Survey participants were asked what restriction they face in expanding in the Chinese market²⁰. In 27% of surveys, industry representatives cited the larger **regulatory environment**²¹ as one of the main obstacles preventing further expansion in the Chinese market. In second place (22%) are the **high prudential requirements**²² for setting up new branches. Industry representatives are concerned that even after 2006 the geographical scope of their activities will remain severely restricted due to prudential requirements. **Licensing restrictions**²³ were mentioned in third place (20%). The micro-management by the Chinese government covering a wide range of other areas, so industry representatives complain, is overly bureaucratic and in many cases is something that should be decided by businesses, not by administrators. This issue was of particular concern in the life insurance industry where difficulties in obtaining provincial licenses hamper further geographic expansion. Following in fourth place (10%), and cited by larger-sized financial institutions in particular, are the **current restrictions on ownership**.²⁴ The difficulty of **recruiting & retaining capable staff** is also

highlighted (10%) while a range of **other difficulties** (12%)²⁵, notably the lack in transparency of local institutions, are also mentioned.

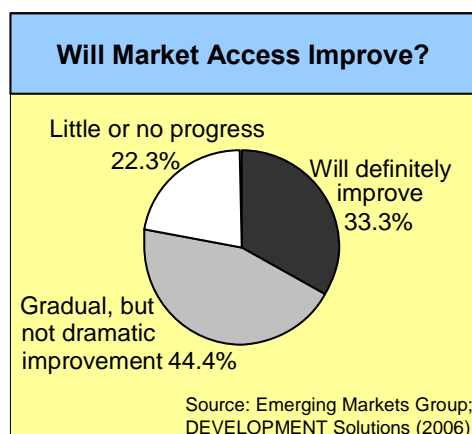


Figure 2: Evolution of Market Access Obstacles

Mostly, industry representatives remain somewhat positive when asked²⁶ whether they believe the current situation on market access obstacles will evolve. However, most respondents (44.4%) expect only gradual, but not dramatic improvements. 33.3% of respondents are more optimistic and expect a more whole-sale change to take place. A minority of respondents (22.2%) expect to see little or no progress.

Annex 5 provides a visual summary of both the market driven competitive forces as well as those derived from non-tariff barriers (NTBs).

3.5 Economic Costs of restricted Market Entry²⁷

In a simplified model for this paper²⁸, the quantitative costs due to restricted market entry for foreign competitors in the **banking sector**, as depicted above, are assumed to be mainly based on:

Administrative Barriers despite WTO Implementation:

- Delayed branch opening: 1 per year, 1 at a time
- Costly branching: capital and liquidity requirements, as if a new bank license is required
- Restricted RMB refinancing on interbank market

Main short-term effects of administrative barriers on business development:

- Heavy negative impact on retail (deposits) business (assumption: 70% of their potential business volume withheld from foreign banks until 2010)
- Heavy negative impact on RMB lending business (assumption: 50% of their

potential business volume withheld from foreign banks until 2010; impact lower than on deposit business, since some lending can be affected based on interbank market refinancing)

- Medium negative impact on foreign currency lending business outside large commercial cities (assumption: 30% of their potential business volume withheld from foreign banks until 2010)

As a result and summarising the estimations as detailed in **Annex 1**:

- In retail RMB deposit business, foreign banks could face a progressive loss in potential business volume (on average about 70% of their potential business volume).²⁹ For European banks, this would, under the assumptions made in the model, create progressive opportunity costs due to foregone business opportunities rising by 2010 up to 1.8 billion €;
- In the RMB lending business, this lost market share is estimated at ¼ in the first years and could amount up to 50% by 2010 or 1.2 billion € in opportunity costs;
- In foreign currency lending, business losses are entering with a lower share but could still amount up to 1/3 by 2010 of the "feasible" business volumes, or 175 million € in opportunity costs

In the long run, and without proper access to both RMB deposit and lending business, foreign banks will not be able to keep/enlarge their competitive position in China, but will be marginalised by Chinese banks with improved performance. Without proper access to RMB deposit and lending business, the business model of setting up fully foreign owned banks with fully-fledged operations in China will become obsolete. Remaining successful business models would then only be specialised banks (e.g. investment banking) or the participation of European banks (usually as minority shareholders) in Chinese banks. Given that foreign banks already have a strong foothold in foreign currency lending in major commercial cities, no additional long-term negative effect of existing barriers apart from the short-term costs estimated above are expected. The remaining indirect constraints on expanding foreign currency lending of European banks should therefore not render strategic negative effects, in particular since the role of foreign currency lending in China in general is expected to diminish in comparison to RMB lending.

As for **the insurance sector**, assumptions as detailed in **Annex 2**, are based on:

Main Administrative Barriers despite WTO Implementation:

- Non-life sector restrictions: motor third party liability insurance
- Life-sector restrictions: no stand-alone foreign insurance companies

Main short-term effects of administrative barriers on business development:

- Heavy negative impact on foreign stand-alone non-life insurance companies due to restrictions in motor vehicle insurance (assumption: 25% of their potential business volume withheld from foreign insurers until 2010)
- Heavy negative impact on foreign life-insurance providers due to impossibility of going stand-alone (40% of their potential business volume withheld from foreign insurers until 2010)

As a result, opportunity costs for European insurers of non-access to motor insurance in non-life insurance business could amount to 20 million € by 2010, and costs due to not allowing stand-alone life insurers could amount to 220 million € by 2010.

In the long run, significant negative effects are mainly seen, if foreign insurers are not allowed to set up stand-alone operations in the hugely growing life-insurance business. Given the insurance industry's increasingly important future role as a substitute for social security provided previously by state bodies or SOEs, this market is of very high potential. When forced to work as minority shareholders with Chinese partners, neither products nor procedures of European insurers can be protected, nor will European insurers then be able and willing to apply their full home grown expertise.

3.6 Evaluation of Environment for European Investors

With regard to the main drivers for entering a market by financial institutions (location, ownership, internalisation advantages), there is evidence that the "run to the Chinese market" might be explained by other factors, (such as first-mover advantages, follow the customer strategy, banking on change, etc.) but seemingly not with respect to these main economic drivers.

Location advantages remain limited, and even after formal opening of the market by year-end 2006 foreign banks will be faced with a difficult and disadvantageous operating environment. As described above, purely foreign banks and insurance companies face prohibitive costs in setting up a large branch network, partly due to the consecutive "branch by branch" licensing

treatment, and partly by treating every bank branch as a separate banking entity with resulting costs due to excessive capital and liquidity requirements.

Ownership advantages on the one hand remain restricted for banks in RMB business through "practical impediments" such as state control over many potential loan clients (in particular SOEs) and "market conditions" which continue to allow Chinese banks to lend at interest rates below (risk) cost coverage level. Adding to that, existing regulations impede foreign banks from competing for deposits via higher deposit rates, keep foreigners partly out of the growing trade finance business with Chinese companies and limit the possibilities of cross selling and synergetic use of funds. This is due for example to the fact that FX deposits cannot be used as collateral against RMB loans. Some restrictions also apply, albeit to a lesser extent, to foreign currency business of foreign banks.

In the insurance sector, the provisions that wholly foreign-owned companies may only engage in non-life insurance, and in this field are also barred from the mass business of third party motor liability insurance, is a strong disincentive for setting up subsidiaries. In general, of course, the regulations that foreign investors in principle cannot obtain more than 20% (or 25% for a group of foreign investors) of Chinese banks and insurance companies severely hampers the realisation of ownership advantages. Extensive involvement by foreign financial institutions in the Chinese banking and insurance market inevitably means some kind of partnership with or investments into Chinese financial institutions - investments which are quite far from being a secure option since so far, no controlling stakes can be obtained. In the banking sector, however, apart from several major banks that are considered critically important, the government seems willing to dilute its stake in the wider banking sector over the near-to-medium term.

Similarly, given the market dominance of a few Chinese companies in the insurance sector and the problems of finding qualified sales agents or building up other distribution channels, most foreign institutions opt to invest into Chinese insurance companies. This means accepting the dominance of the Chinese partner, thus contradicting the principle of ownership advantage. Even when European or other foreign investors manage to find ways to participate in management, significant control nevertheless remains to be seen. One strategy for foreign insurance companies to ensure management control

has been to partner with non-financial Chinese institutions.

Indirect internalisation advantages: In the banking sector, banks have knowledge advantages about the long-term customers in their home country. After long-term business cooperation between firms and banks of the same country, home country banks can offer tailor made services that cannot be easily copied by host country banks. This “follow the customer strategy” is prominent and an area where foreign banks will probably preserve their competitive position. With the insurance sector the situation is different, since a “customer seeking strategy” must be pursued, i.e. business must to the largest extent be developed with clients located in China.

4. THE CHINESE BANKING AND INSURANCE SECTOR

4.1 Operators in the Chinese Financial Sector and Sector Trends

4.1.1 Banking Sector

The Chinese banking sector, comprised of about 30,000 financial institutions with more than 2.8 million employees in more than 500,000 banking units, has by strictly physical measures, to be considered as one of the world’s largest markets. Although when comparing total banking sector assets of 2,801 billion €, with that of the European banking sector assets (29,010 billion €) or the US (7,580 billion €) the Chinese banking sector seems relatively small, it is considerably larger than those of the ASEAN region (1,884 billion €).

Putting aside for the moment the increasingly important role for China’s three policy banks (see below), the sector is still dominated by the four large state-owned commercial banks (SCBs). Indeed, smaller banks with weak financial profiles, those lacking a niche market or a clear advantage enabling them to compete with larger institutions, are likely to be snapped up by their stronger peers. The

central government and local authorities are likely to encourage consolidation of weaker or smaller banks to increase their chances of survival. Those with satisfactory market positions in major cities may attract the attention of foreign investors, which can provide the capital and skills to enable them to compete with their larger competitors. In addition, the timing of government support increases the degree of polarisation. Chinese financial institutions can be categorised along the following lines:

The “big players”, the group of the dominant four SCBs³⁰ and one joint stock commercial bank³¹ have a share of 54% in total banking sector assets and about 60% of total loans outstanding (1,213 billion €). These banks still enjoy a superior level of public confidence, which translates into low costs (lower marketing and other expenses per customer), a strong customer base and a large network. Due to these strong foundations, these banks are in a strong position to develop consumer lending and fee-based products and have distinct competitive advantages over their smaller competitors (joint stock commercial banks, city commercial banks, rural credit cooperatives, foreign banking institutions).

The policy banks³² were established in 1994 with the goal of taking over the policy-lending function of the SCBs and to relieve the central bank of the need to indirectly fund the capital requirements of policy lending. These banks have a combined market share of about 8% of banking system assets. The policy banks accept few deposits, obtaining funding primarily through the issuance of bonds. Despite not having assumed any existing policy loans from the four state-owned commercial banks, the policy banks have grown significantly. Initially capital was provided by the state and funding has been raised through state-supported domestic and international bond issues. Due to the magnitude of China’s continuing policy funding needs, increasing prominence for the policy banks is expected.

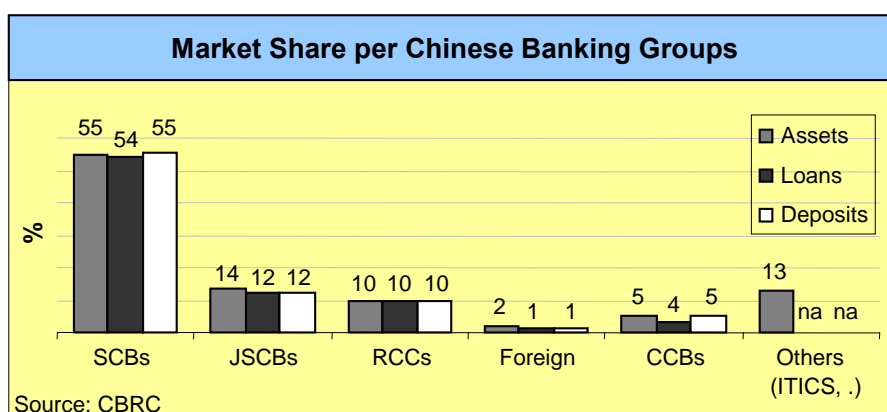


Figure 3: Market Shares of Banking Groups in China

The national banks³³ are joint stock commercial banks (JSCBs) with a market share of around 17%, where equity ownership is distributed among the central government, local governments and other investors. These banks are permitted to engage in all forms of general banking, including foreign exchange and international transactions, and effectively compete for deposits and loans, for instance with the large banks, where they have some comparative advantages. These banks in general have a less burdensome NPL legacy, and compete aggressively with the large banks in the corporate banking segment. However, as the country's corporate bond market develops, this strategy may become less viable over the medium term.

The 117 city commercial banks (CCBs) have a market share of about 6%. These banks have their origins in urban credit cooperatives, of which 681 still exist, and primarily service households and SMEs. Accordingly, they usually operate within the boundary of the cities in which they are domiciled. They are characterised by weak franchises, poor asset quality, a limited customer base and will see increasingly severe competitive pressure from their larger competitors. Their future is likely to rest on their ability to develop workable business models to serve local SMEs, one of the reasons for equity participation of international finance institutions, such as IFC, KfW, etc. Mergers and acquisitions on international level have been concluded for nine banks³⁴ and more are underway. The pace of consolidation is likely to increase in line with rising competitive pressure from the reforming large state owned banks.

Rural credit cooperatives (RCCs) and rural commercial banks: about 38,000 of these usually very small institutions have 11% of market share and provide credit to small collective enterprises, SMEs and individuals in rural areas. This banking group is marked by a consolidation processes. Since 2004, the government has been restructuring this segment and transferred control to provincial or municipal governments (in the case of rural cooperatives) and shareholders (in the case of rural commercial banks). In the past, the regulators had supervisory authority and high levels of management control over these institutions, leading to a direct conflict of interest. This group has to be considered the weakest within the banking sector.

Non-bank Financial Institutions comprise 59 trust and investment companies (TIC), 74 finance companies, 12 leasing companies, and 5 auto financing companies. To be added are more than 70 finance companies, and the

countrywide postal savings sector. Larger TICs closely identified with provincial governments are often known as international trust and investment corporations (ITICs). Since the failure of Guangdong International Trust and Investment Corp. in October 1998, a liquidity crunch has plagued this sector. The regulations governing TICs have been revised since the GITIC failure, and they are no longer allowed to take deposits or borrow money by issuing bonds, domestically or elsewhere.

Foreign banking institutions have a small share of about only 2% in total banking sector assets, but about 20% of total loans outstanding denominated in foreign currency. At the end of 2005, 71 foreign banks from 20 countries were operating in China, together operating 238 branches compared with 180 in 2002, most of them from the EU, US or Japan. Most of the foreign banks are located in major business centres such as Beijing, Shanghai, Guangzhou and Shenzhen. Conditions in China have developed enough to attract investment from the world's biggest credit card issuers in the last year. Currently, Citigroup, American Express, and HSBC Holdings have signed credit card partnerships with Chinese banks. However, branch operations will remain largely limited to providing treasury transactions and trade finance to companies domiciled in the same country or territory as the bank, other foreign corporations, or Sino-foreign joint ventures. Although officially entitled to do RMB business with Chinese corporate companies and individuals (from January 2007 onwards), other limitations and the lack of refinancing possibilities will lead to low engagement of foreign banks in the RMB market.

Short-Term Development trends of Chinese Banks

With WTO accession, China will not only reap the benefits of improved access to world markets, but will also have to accept that in a number of sectors, for example the banking sector, some degree of market share of local companies will be lost to foreign competition. While the share held by foreign competitors is currently rather small (2%), this could climb up to 10 or 15% by 2010.

Opening the financial sector to foreign competition in principle means opening the door to China's domestic saving pool, estimated to be worth between 1.5 and 1.7 trillion USD, and thus to Chinese banks' most relevant refinancing base, since financial markets (e.g. interbank market) are not yet fully developed. This savings pool, so far largely monopolised by the four big state owned banks, will be subject to strong competition between different types of Chinese and foreign banks. Saddled by bad

debt and under-performing assets, the Chinese banking system is deprived of this important source of funding. This might affect the overall stability of the financial system and will certainly hit weak performers hard. As a result, Chinese authorities will be hesitant to liberalise the financial sector too quickly. The Chinese government has, therefore, a significant incentive to restrict the amount of foreign owned branches in the Chinese market and limit foreign ownership of existing Chinese banks. This concern will remain at the forefront for the foreseeable future shaping government policy in this area. By implication this might mean that it will be difficult for foreign institutions to implement an organic growth strategy in practice and only limited liberalisation will therefore realistically take place. In terms of a partnership strategy by equity participation in a Chinese bank it must be clear that the Chinese government sees this as an opportunity for foreign banks to provide knowledge transfer while allowing the banking system to mature before any real competition could affect Chinese banks.

In the shorter term, the larger, mostly underperforming, Chinese banks will be increasingly challenged not by foreign players, but by smaller, better performing Chinese banks. The Big Four banks have already lost about 20% market share to smaller players (such as city commercial banks) over the last 15 years. Although Chinese joint stock and city commercial banks in the past were constrained by restrictions on their fund raising, unlike directly state-owned banks, they were less subject to "directed credit" towards SOEs. They also had a more diversified loan portfolio (consumer loans, mortgages and SME loans) and due to tighter budget constraints they have developed better credit and risk management. Deposit and loan markets are nevertheless still dominated by state-owned commercial banks; those banks however, fail to capture a comparable share of the profits and thus are large in size but poor in asset quality. Privatisation, restructuring or liquidation of such institutions would of course also leave some (new owners, depositors, the state) with the existing balance sheet risks and/or losses, but also offer opportunities for foreign institutions. There is every reason to believe that foreign entrants will further increase the pressure on the large SCBs.

4.1.2. Insurance Sector

When compared to the banking sector, the Chinese insurance sector is still rather small, with total assets as a percentage of GDP (2004) standing at only 9.4% (banking sector: 23.1%). The Chinese insurance sector is

comprised of around 80 institutions providing insurance services. Of these, 40 are Chinese companies, including six holding companies (with 16 subsidiaries) 35 . 37 foreign insurance companies are present in the market, either through branches, joint ventures or as investors in existing Chinese insurance companies. Additionally, there are 234 insurance brokers, of which four are with foreign participation. Approximately 124 foreign insurance companies have set up representative offices in China, thus creating the formal conditions for a possible later engagement in the market through a branch office.

As in the banking sector, the insurance sector continues to be heavily concentrated with a handful of key players. The combined share of the three biggest non-life insurers (China People's Property and Casualty Insurance Company, China Pacific Property Insurance Company, and China PingAn Property Insurance Company) despite dropping to 79.9% from highs of 89.3% a few years ago still reflects the high concentration within this sector. Foreign participation in the non-life market purely in terms of numbers is significant, with 10 out of 26 companies in the non-life sector being foreign or with foreign participation. Of these ten, 2 are from the EU (Allianz from Germany and Royal & Sun Alliance from the UK), 3 from the US, 1 from Switzerland and 4 from Japan. Insurance companies from ASEAN countries are not represented in the Chinese non-life market. Foreign insurance companies have made full use of the fact that in the non-life sector they can establish their own branches without a Chinese partner. All engagements, except for a 10% participation of the US-based AIG in China's largest non-life insurance, IPCC Property & Casualty, are stand-alone branches without a Chinese partner. Through this participation in PICC, however, AIG is believed to have captured the largest market share of all foreign non-life insurance companies in China.

On the life insurance side, the combined share of the three largest Chinese life insurers (China Life Insurance Company, PingAn Life Insurance Company and China Pacific Life Insurance Company) dropped from 86.6% to 83.2%, but they still dominate the market. Foreign companies, who may not offer life insurance products directly, are engaged with 21 out of 28 life insurance providers in China; the strongest foreign participation in market shares seems to be with HSBC's 19.9% share in PingAn Health Insurance and US-based AIG's 14.5% participation in China People's Property and Casualty Insurance Company Limited (PICC).

With 11 out of 21 engagements of foreign insurers operating in the Chinese market, European companies seem well placed in this growing market (US: 5, Australia: 1, Canada: 2, Singapore: 1, Japan: 1).

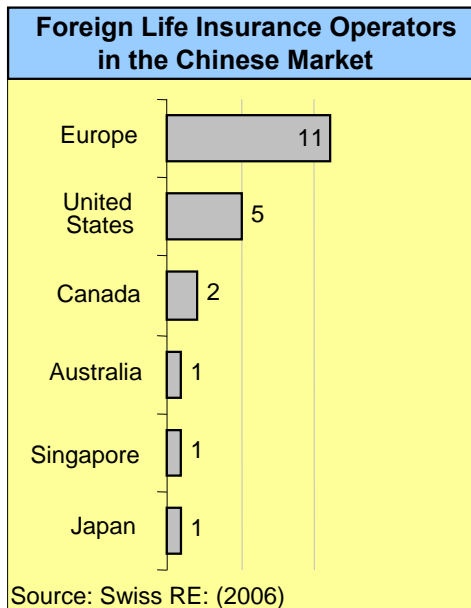


Figure 4: Foreign Life- Insurance Companies in the Chinese Market

The largest Chinese non-life insurance company is the China People's Property and Casualty Insurance Company Limited (PICC), the former state monopoly founded in 1949.³⁶ It currently dominates the domestic market with around 58% and continues to be majority-owned by the state (around 69% by PICC Holding Company), while the US-based AIG has a 14.5% stake and the remaining shares are held publicly. Besides the advantages of this historical legacy, PICC's continued dominance is ensured by its close connections with SOEs and the ability to operate as a "full-service" insurance provider (including in segments not allowed to foreign companies) with competitive products and aggressive pricing. China PingAn is distinguished by its commercialised corporate and sales culture, by an aggressive, innovative marketing style, and by its rapid growth. China PingAn, with roots in the entrepreneurial south of China, has been most successful at nurturing relationships with China's dynamic and growing private corporate sector. It holds about 10% share in both life and non-life markets. Other relevant "competitors" are the China Pacific Insurance Holding Company, established in 1991, with around 12% of the market, Huatai Insurance Company, established in 1996 (mainly owned by 54 local companies across various industries) and ACE Insurance Company Limited.³⁷ As a main trend, the Chinese insurance market developed from one that was dominated by the corporate sector and

other non-life (property and casualty) insurance, to one that is now dominated (as in developed countries) by the individual market and life insurance³⁸.

The market proportions of life and non-life have changed, but at the same time, both markets have grown dramatically. The most dramatic growth is clearly in life insurance, in which premiums increased from USD 10.7 billion to USD 38.8 billion between 1999 and 2004. In the non-life sector, premiums during the same period have "only" doubled from USD 6.3 billion to USD 13.2 billion. Foreign non-life insurance companies accounted for only 1.22% (2004) of non-life insurance premiums in China, while foreign life insurance companies (i.e. joint ventures with Chinese partners) had a 2.64% share of the life insurance market. In the major business cities of Shanghai and Guangzhou however, foreign companies hold market shares of 15% and 8% respectively. Only after 1992, China gradually approved the re-entry of 16 additional leading foreign insurers. While economic reforms in China have increased foreign participation in the insurance industry, the combined market share of foreign and joint-venture companies remained limited despite predictions of dramatic growth following China's concessions upon entry to the WTO.

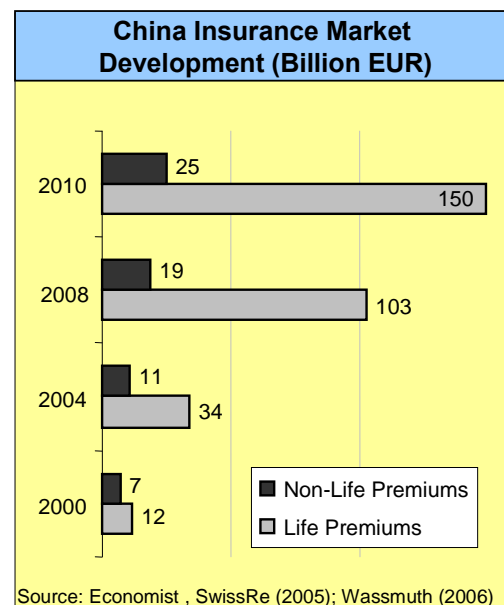


Figure 5: China Insurance Market Development

4.1.3 Foreign Investments in China's Banking Sector

To date, only a limited number of foreign banks have established a presence in China of any significant size. These banks are led by the UK's HSBC, Standard Chartered Bank and Royal Bank of Scotland, and from the US-side by Citigroup, Bank of America, and (recently) Goldman Sachs, all of which have

a large presence in Asia already. On the European side, besides the three British banks mentioned, Deutsche Bank and Allianz/Dresdner Bank (both German) and ING (Netherlands) are sizeable investors in Chinese banks as well. Several others have established a limited physical presence.

As shown in **Table 4** below, only a few foreign institutions have taken significant stakes in local banks, investing about 13 billion USD. Stand-alone operations of foreign banks in China comprise about 238 branches and, although no exact data is given, feature a similar amount of equity investments as those made by foreign institutions in Chinese banks. However, none of the foreign stand-alone banking operations in China on its own has any significant market share. The majority of recent European banking investments have been made through the acquisition of minority stakes. In fact, the

minority stake option tends to be potentially risky, although it has a greater potential upside. Despite the uncertainty surrounding the returns on these stakes, profits on investment are expected to be seen in the long term. While minority stakes in domestic banks realistically appear to be the quickest means of obtaining significant access to the Chinese market, there is considerable uncertainty regarding the foreign banks' ability to convert these stakes into controlling participations, even over the long term. The use of joint venture operations and strategic partnerships, arranged in combination with the acquisition of a minority stake, is a reflection of this concern. To summarise, banks in China must overcome barriers to entry including limits on foreign investment in domestic banks, very high working capital requirements for each new branch, and a high degree of penetration and entrenchment by local players.

Table 4: Foreign Investments in Chinese Banks

| Chinese Bank | Foreign Financial Institution | Equity %-age | Inv US\$ bn | Year |
|---------------------------------------|--------------------------------------|--------------|-------------|------|
| Bank of Shanghai | IFC (international) | 7 | 60 | 1999 |
| | HSBC (Europe) | 8 | 63 | 1999 |
| Shanghai Pudong Development Bank | Citibank (USA) | 5 | 72 | 2003 |
| China Minsheng Banking Corp. | IFC (international) | 1.6 | 24 | 2003 |
| | Temasek (Singapore government) | 4.6 | 70 | 2003 |
| Industrial Bank | IFC (international) | 5 | 65 | 2003 |
| | Gulf Investment Corporation (Kuwait) | 4 | 52 | 2003 |
| Xian City Commercial Bank | Bank of Nova Scotia (Canada) | 2.5 | 3 | 2004 |
| | IFC (international) | 2.5 | 3 | 2004 |
| Shenzhen Development Bank | Newbridge Capital (USA) | 17.9 | 150 | 2004 |
| Bank of Communications | HSBC (Europe) | 19.9 | 1,175 | 2004 |
| Jinan City Commercial Bank | Commonwealth Bank of Australia | 11 | 17 | 2004 |
| China Construction Bank | Temasek (Singapore government) | 5 | 1,400 | 2005 |
| | Bank of America (USA) | 9 | 2,500 | 2005 |
| Bank of Beijing | ING (Europe) | 19.9 | 215 | 2005 |
| | IFC (international) | 5 | 53 | 2005 |
| Bank of China | Royal Bank of Scotland (Europe) | 10 | 3,100 | 2005 |
| China Bohai Bank | Standard Chartered Bank (Europe) | 19.9 | 120 | 2005 |
| Hua Xia Bank | Deutsche Bank (Europe) | 14 | 500 | 2005 |
| Nanjing City Commercial | BNP (Europe) | 20 | 36 | 2005 |
| | IFC (international) ³⁹ | 5 | 9 | 2001 |
| Hangzhou City Commercial Bank | Commonwealth Bank of Australia | 19.9 | 78 | 2005 |
| Nanchong City Commercial Bank | KfW (Europe) | 10 | 5 | 2005 |
| Industrial and Commercial Bank (ICBC) | Goldman Sachs (USA) | 6 | 1,800 | 2006 |
| | American Express (USA) | 0.7 | 200 | 2006 |
| | Dresdner Bank (Europe) ⁴⁰ | 3.3 | 1,000 | 2006 |

Source: Wassmuth (2006)

4.1.4 Foreign Investments in China's Insurance Sector

On the insurance sector side the presence of foreigners is differentiated according to life and non-life insurance. Whereas in non-life

insurance, foreign institutions make use of the legal possibility to set up their own company in all but one case, in life insurance they are confined to investing in a Chinese company, or building-up a joint venture.

Table 5: Foreign Investments in Chinese Insurance Companies

| Chinese Life Insurers | Foreign Investor | Equity %-age | Year |
|---------------------------|------------------------------------|--------------|------|
| Ping an Insurance | HSBC (Europe) | 19.9 | |
| XiangCai Insurance | ABN Amro (Europe) | 33 | |
| PICC Health Insurance | DKV (Europe) | 19 | 2004 |
| Life Insurance JVs | Foreign Investor | Equity %-age | Year |
| Axa-Minmetals | AXA (Europe) | 51 | 1999 |
| Allianz Dazhong | Allianz (Europe) | 50 | 1997 |
| CMG China Life | Colonial Mutual Group (Australia) | 49 | 2000 |
| CITIC Prudential | Prudential (Europe) | 50 | 2000 |
| John Hancock Tian An | John Hancock (USA) | 50 | 2000 |
| Sun Life Everbright | Sun (Canada) | 50 | 2000 |
| ING Hua Tai Capital Life | ING (Europe) | 50 | 2000 |
| Generali China | Generali (Europe) | 50 | 2000 |
| Aegon-CNOOC Life | Aegon (Europe) | 50 | |
| Aviva | Aviva (Singapore, ASEAN) | 50 | |
| Cigna & CMC | Cigna (USA) | 50 | 2003 |
| Haier New York Life | New York Life (USA) | 50 | |
| Heng An Standard Life | Standard Life (USA) | 50 | |
| Manulife-Sinochem | Manulife (Canada) | 50 | |
| Nippon Life | Nippon Life (Japan) | 50 | |
| Pacific Antai | ING (Europe) ⁴¹ | 50 | 1997 |
| Skandia Insurance | Skandia Insurance (Europe) | 50 | |
| Fully Foreign-Owned Life | Foreign Investor | % | Year |
| AIA ⁴² | AIG (USA) | 100 | 1995 |
| Chinese Non-Life Insurers | Foreign Investor | % | Year |
| PICC Property & Casualty | AIG (USA) | 14.5 | 2003 |
| Fully Foreign Non-Life | Foreign Investor | % | Year |
| Allianz | Allianz (Europe) | 100 | |
| Federal Insurance | Federal (USA) | 100 | |
| Mitsui Sumitomo | Mitsui Sumitomo (Japan) | 100 | |
| Liberty Mutual | Liberty Mutual (USA) | 100 | 2003 |
| Royal & Sun Alliance | Royal & Sun Alliance (Europe) | 100 | 1998 |
| Samsung Fire & Marine | Samsung Fire & Marine (Japan) | 100 | |
| Sompo Japan | Sompo (Japan) | 100 | |
| Tokio Marine & Fire | Tokio Marine & Fire (Japan) | 100 | |
| Winterthur | Winterthur (Switzerland) | 100 | |

Source: Wassmuth (2006)

4.2 Segmentation of the Chinese Financial Market

4.2.1 Banking Sector

For the purposes of this study, the main business fields of foreign competitors in China have been grouped according to the following customer groups and their financing needs: Corporate Banking; Retail Banking; and Investment Banking and Treasury. Among the European financial Institutions surveyed for this study, the main focus of operating in the financial market remains corporate banking (31%) with a focus on European and other foreign customers (39%). Increasingly, asset management and the retail sector are becoming important for European banks but often in cooperation rather than in direct competition with Chinese financial institutions.

Corporate Banking

Corporate banking mainly services medium and large enterprise clients and focuses on Corporate Lending, Project Finance, Trade Finance and Treasury.

Due to the already large customer base in this area, and the growing financing needs of total loans extended to Chinese corporate borrowers. In general, corporate lending is only marginally profitable, due to fierce competition, the high cost of risk pricing and refinancing costs.

The relatively undeveloped Small and Medium-Sized Enterprises (SME) sector represents a huge potential growth market due to this sector's increasing contribution to China's GDP at a time when the SOE sector is diminishing in importance. Due to ideological prejudice, SMEs (often privately-owned) have historically not been integrated into the financial system. This sector is still often

private enterprises, the Corporate Lending field in China has significant potential. However, corporate lending is not without its risks due to insufficient creditors' rights or creditor information systems, unreliability of collaterals, lack of experienced loan officers in loan/finance approval, and so on. The corporate segment is already considered intensely competitive by the majority of foreign banks as corporate business represents at least 90% of overall banking business in Chinese banks. Foreign banks have only been entitled to lend in RMB to Chinese corporate customers since 2004 and many restrictions, remain in place. Therefore the share of foreign institutions in loans extended remains very limited (about 1%)⁴³ compared to the overall size (and potential) of the Chinese loan market. The loan portfolios of foreign banks are typically composed of a relatively high percentage of smaller loans (with limited risk exposure) and a large percentage of offshore loans to foreign customers (e.g. customers located outside of China with a production unit in China). Only a very limited number of foreign banks operating in China have more than 40% of their

considered as highly cost intensive and risky sector by the banks, which to some extent can be resolved by concentrating activities on this sector to realise economies of scale and diversify risks. Due to these risks and still limited interest among Chinese banks, many of the financing needs of this group still have to be covered by international development institutions, who refinance Chinese banks' loan portfolios to SMEs (currently with a strong focus on various City Commercial Banks, where a couple of development organizations such as IFC or KFW have invested equity as well).

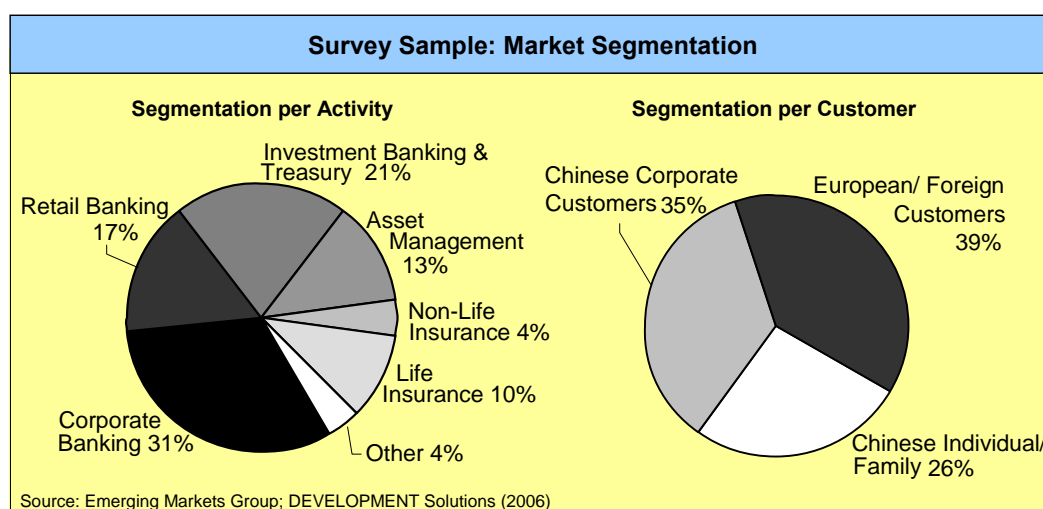


Figure 6: European Financial Sector in China Survey Results

Relative to the other corporate business fields, Trade Finance represents the most profitable part of the Chinese market for foreign banks. Here they also have their biggest competitive strengths at present, since many banks have followed their global customers into China, for instance addressing their trade financing needs. This also reflects the still restrictive regulatory environment hampering other financial service provision to both foreign and domestic clients as depicted above. Trade finance with and for Chinese companies, however, is often hampered by a regulation on foreign currency and foreign debt, which requires Chinese companies to register such facilities as "new external debt" (cf. section 3.1.2). According to the PBOC, foreign banks now claim 25% of the trade finance market in China despite these hindrances.

Chinese companies at present rely almost entirely on bank debt for financing, but over the next ten years it is likely that the development of capital markets will reduce demand for loans. Furthermore, as Chinese companies centralise their cash management, their corporate deposit "stocks" held by each of their provincial operations will be greatly reduced. All in all, corporate banking still represents the largest share of the sector's profits, but this relative importance will decline as profits from retail banking increase more quickly.

Retail Banking

Retail banking mainly addresses SMEs and individual customers, and focuses on business fields such as transaction banking (e.g. money transfer services), credit cards business and saving or investment products. Foreign banks attach increasing importance to this field and most of them include the growth of this business area in their strategic plans, despite that many parts of this business field are currently only marginally profitable. The seemingly huge market with more than a billion potential customers however, seems not so easy to tap for foreign banking institutions, given the restrictive practical and regulatory environment.

Chinese banks have increasingly turned their attention towards the retail business in which they have the natural advantages of large branch networks and huge client bases. It is estimated that about half of the profits of Chinese banks will come from retail business by 2013. These estimations are sustained mainly by a strong, and increasingly consumption-driven, GDP growth, ranging between 7-9% in recent years. Growing prosperity will also boost demand for retail-lending products such as car loans, credit cards and mortgages. Despite difficulties in

banking "en-masse" the shift in market potential from corporate to retail banking still gives foreign banks a golden opportunity to tap into the Chinese banking market by targeting highest-income bracket, affluent customers. Banks such as HSBC and Standard Chartered for example are setting up extensive branch networks to access wealthy customers while relying on their shares in Chinese banks to access the middle-lower market segments. The financial needs of very affluent customers are diverse, and they account for the vast majority of auto, mortgage, and personal-lending balances. Although they make up a mere 2% of the retail customers of banks in China, they account for as much as 55-65% retail-banking profits. The "mass-affluent" segment accounts for 18% of all customers and for 40-50% of retail-banking profits, while the 80% of normal customers in the mass-market segment are largely unprofitable.

A particular field of interest for foreign banks in the coming years within retail business is the bank card (Credit/Debit) industry, where networking restrictions are a major impediment, unless partnering with a Chinese bank. Citigroup, American Express and HSBC, are already issuing co-branded dual-currency cards in China through their local partner institutions. China now has the second-largest bank card sector after the United States with about 850 million cards issued, only about 11% less than the amount of cards issued in the US. However, most of these were debit cards with only 35 million credit cards issued (debit cards transactions must be withdrawn directly from the local bank account of the owner). Nonetheless credit cards are an increasingly popular segment. The infant credit card industry is fiercely competitive with overhead costs for marketing high in the short term. The market appears to be enormous, but it has to be remembered that China still remains a "cash" society. Thus to increase credit card usage and competition among different credit cards, credit card companies use different advertising tactics with the hope of increasing credit card transactions. To remind cardholders to use their credit cards, companies offer cash rebates, discounts at selected retail stores, free annual fees, reward points and actual gift rewards.

Nonetheless, this business field is supported by the state, since it provides a unique possibility to build up a "credit data bank" (CRCS-System) of customers and potential future loan loss customers. According to the Beijing municipal government's credit card development plan, by 2008 90% of business establishments in Beijing will accept cards, and card purchases will account for 25% of

total consumption. However, in order to broadly implement efficient use of credit cards, China must vastly increase its capabilities in terms of credit ratings, technology and vendor services. This presents a business opportunity for foreign partners who have the ability to implement these based on their depth of experience in this area.

Investment Banking and Treasury

This business field mainly addresses larger enterprises or fortunated individuals. Investment banking includes capital market business in debt and equity, such as trade with securities, bonds, shares, credit derivatives and structured products, risk management products (hedging), foreign exchange trading and mergers & acquisitions (M&A). This segment is an increasingly demand driven market with larger opportunities for international banks but success depends upon further development of the market and the regulatory environment, e.g. the development of efficient capital markets and a liberal investment environment.

Capital business in debt and equity can further grow if for instance state owned Chinese banks manage and outsource their loan portfolios through debt swaps. However this depends also on further institutional developments (e.g. regulations) in the corporate bond market. While development of the debt capital market with credit derivatives and in particular securitisation and trading of NPL portfolios is considered to be an area of future importance, several foreign banks believe from a short-term perspective that there are larger opportunities for derivatives linked to equities and commodities.

In the long term, investment banking is seen as a highly profitable field under certain conditions (e.g. management, capacities as well as knowledge of distribution and information channels). In addition, given the possibility for experienced "smaller players" to outperform large state-owned Chinese banks in this field, which requires neither a large branch network nor a solid RMB deposit base, investment banking is an area where foreign institutions have clear comparative advantages.

In line with their focus on wealthy individuals, foreign banks in China expect to acquire a significant share of the market for fund and asset management. Although only a relatively small market for foreign banks today, many see this as an important future business field in which US, but also European banks, should be strong.

4.2.2 Insurance Sector

Apart from the dominant Chinese players (in non life sector: PICC, Ping An, China Pacific; in life sector: China Life, Ping An and China Pacific), other Chinese companies have less than a handful and foreign insurance providers (with the exception of AIA) only have one branch in China. Limitations on branches, along with previous geographical restrictions as mentioned in previous sections, account for the paltry share held by foreign companies while foreign life insurance companies are restricted by their requirement to form joint ventures or take minority equity stakes in existing Chinese insurers.

The major foreign competitors are AIG, the first company to be approved and the only foreign company to be granted 4 licenses to sell both life and property insurances in three cities. ING Insurance, which opened its first representative office in Shanghai in 1993 and received its Joint Venture Life Insurance permit in 2000, and Minsui Marine Insurance Company Ltd., the third largest property insurer in Japan, which has had representative offices in seven Chinese cities since 1981, but only received business approval in the year 2001.

The individual and life insurance market by now dominates the Chinese insurance market. In the life insurance sector (60% of the total insurance market), premium revenues account for one-third group and two-thirds individual insurance categories. Based on trends evident in large cities like Beijing and Shanghai, individual insurance is growing much faster than group life insurance. Within the group insurance category, the largest product is pension insurance, followed by endowment life insurance and accidental injury insurance.

Since 2000, all major life companies introduced investment-linked and dividend-linked products to whole life, endowment life, and pension life products. Pension insurance in particular is seen as a very promising business field for the future. Although the government has in principle installed a statutory pension scheme to substitute for the social security system previously provided mainly by the SOEs, only about 44% of the urban population participate in it. In rural areas the ratio is even lower (only around 10%). Even those insured under the national pension scheme can expect only a minimal amount, which on average stood at only 700 RMB per month in 2003. Private pension schemes through insurance are thus expected to become the choice of many Chinese, into which they would presumably

invest funds currently held as “classic” bank deposits. As with other life-insurance products, pension insurance can only be offered by foreign insurers through their joint ventures or their minority stakes in Chinese insurance companies.

In the smaller non-life insurance market (40% of the insurance market), in property and casualty insurance, virtually all premiums are earned in three categories: Motor vehicle and third party insurance (around 60% of the total in 1999), enterprise property insurance (21%), and cargo transportation insurance (7%). Since they are not yet allowed to do statutory insurance business, foreign companies are still barred from the lucrative field of motor third party liability insurance, and since motor insurance is usually sold in “packages”, also from the first party motor insurance.

At present, there is a high degree of uniformity in product, market, distribution, and pricing strategies among companies in the insurance sector. This is largely a result of historical determinants and the regulatory environment. Foreign insurers’ competitive edge therefore lies in the development of innovative and diversified product lines – whenever regulatory developments. However, in principle the recommendations for the banking sector with regard to product differentiation and quality also apply to the insurance sector in the longer run.

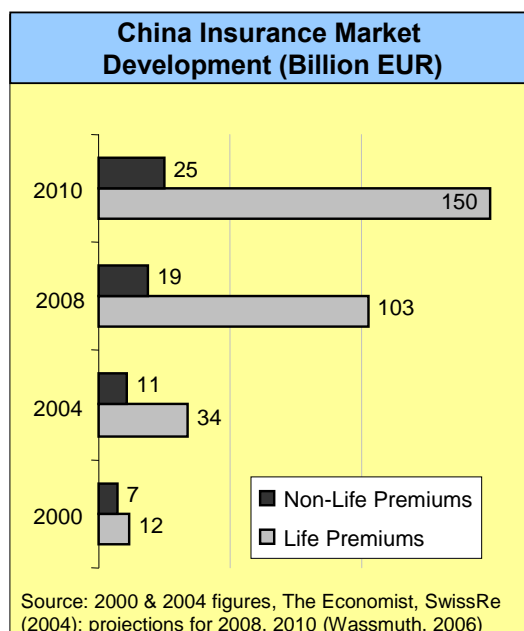


Figure 7: China Insurance Market Development

Notwithstanding the impressive growth rates depicted above, and in principle the enormous market of 1.3 billion inhabitants, the insurance market still has to be

considered to be relatively small and comparable only to smaller European countries. However, there is significant potential for growth (see **Figure 7**). In terms of relative market size and diversification, China for the coming years will probably remain at the low end of those countries with a similar per capita income level, albeit the quantity and quality of products and service providers will certainly continue to develop quickly. In a normal economy, it is realistic to expect insurance premium revenues to increase a few percentage points faster than GDP. In China's case, it is noted, that this growth is even quicker and will probably remain. For example, in 2000, as China's overall GDP increased by some 8%, total insurance premiums increased by almost double that speed (15%). According to experts the annual future growth rate for China's insurance sector as measured by premiums is seen at around 12%. Thus, while perhaps not the El Dorado suggested by some optimists, it is clear that, even based on reasonably conservative assumptions, China's insurance sector will become a significant market within the next years, at least if regulation allows for it.

4.3 Impact of Wider International Financial Sector Developments on the Chinese Banking and Insurance Sector

The Chinese financial sector is influenced by wider international financial market developments. Similarly, the positioning of foreign institutions in the Chinese market and Chinese institutions in the foreign markets will also depend on developments in their respective home countries. Previous studies suggest that international expansion of companies is largely related to their position in home markets, thus mainly large institutions have the tendency to expand, but also companies with less favourable capital and profit positions have a tendency to expand (for example, to tap into foreign local advantages such as local financial expertise, sophisticated markets, etc.). Finally, it might not be excluded that some major international trends will have the potential to spill-over to China, where, in the worst case scenario foreign investors would then have to deal with their already outsourced problems again.

4.3.1 European Banking Sector Development Trends

The European banking sector is marked by an ongoing consolidation processes with the number of credit institutions dropping by roughly 3% each year⁴⁴ (currently at 8,374 institutions). A concentration process accompanies this trend: the 5 largest players currently hold 40.2% in total European

banking assets. When entering China, this trend is to some extent reversed, characterised by expansion (investment, build up of network, recruitment, etc.), thus sometimes contradicting the head offices' strategy in home countries. On the other hand, the results of the consolidation process might change competitive conditions and further improve the efficiency of European banks. In particular, entering the Chinese market with better efficiency and stronger capital bases will make it easier to fulfil Chinese capital requirements.

Another aspect is the diversity of the European banking market, both in regulation and in efficiency and productivity. The use of capital and labour in providing similar services in a sector that shares a common technology is quite heterogeneous across the EU. Figures for banking sector capacity indicators (assets per employee) vary between 882,000 € (Poland) and 30,826,000 € (Luxembourg), while the European average stands at 11.077.000 €. Furthermore, rules and regulations for the banking sector still differ across Europe, and even banking products tend to be specific to each country and cannot easily be sold in neighbouring countries. Such diversities of course render it difficult for EU Trade Policy to define a "common cause" when confronting a centrally-guided China in trade and investment negotiations, e.g. under the WTO framework. However, as will be discussed below, a common approach to EU Trade Policy is regarded by industry representatives as pivotal for successful negotiations.

Funding structures in the European banking sectors underwent substantial changes in recent years. This can be attributed both to structural trends (e.g. the increasing degree of private pension savings' schemes, the changing composition of households' and firms' financial wealth, changes in preferences, shifts in the funding strategies of European banks) as well as cyclical developments (low interest rate environment and changing risk/ return trade-offs). Hence with a loan-to-deposit ratio of 120% and limited growth of deposits, European banks had to diversify their funding. At the same time, banks were drawn to compete more heavily in attracting deposits, by offering higher interest rates and introducing enhanced deposit products. In many EU countries, the securities market has grown rapidly over the past couple of years up to € 243.5 billion (2004) and thus posing an important alternative for bank refinancing. The issuance of residential mortgage backed securities (RMBS) forms the largest segment (nearly 50% of total issuance in 2004), followed by securities backed by receivables

(€ 32.5 billion) and collateralised debt obligations, i.e. securities backed by enterprise loan portfolios (€ 25.2 billion).

Furthermore, and linked to the development of the securities market, European banks while trying to maintain their position in traditional lending practices, are increasing their activities in credit risk transfer markets. In this way, loans are granted, but the respective credit risk is transferred to third parties, a trend which is reinforced by Basel II regulations. The importance of banks may change as corporate clients and governments become increasingly interested in issuing bonds instead of taking bank loans, whereby the role of banks changes from that of creditors to originators and traders of securities. While European banks are slowly changing their role from an intermediary between borrowers and depositors towards risk transfer agents, it is not certain to what extent these trends will spill over into the Chinese market. From the perspective of risk transfer agents, many of these "products" might be too mature for the developing Chinese market on the one hand, and on the other hand would definitely require a deep understanding of the Chinese formal as well as informal institutional framework. It is therefore a risky proposition to introduce these new business practices to the Chinese market un-adapted to local conditions. However, credit risk transfer activities such as debt-equity swaps may present large opportunities, where Europeans ultimately have superior technical knowledge and expertise— providing these competencies can be fine tuned for the Chinese market.

4.3.2 US Banking Sector Development Trends

The consolidation and concentration processes experienced by the European banking sector can also be seen in the US. Similarly, capital market developments represent an increasing source of funding (when compared with bank loans). Bank loans are increasingly outsourced to third parties who carry the risks, a trend which is a lot more advanced in the US than in the EU, as shown by the significantly lower banking assets to GDP and bank loans to GDP ratios. Today, the US banking sector is clearly separated into a large number of banks working only regionally and domestically, and a core group of very professional global players who act on every international level, where they are very competitive. Since US separative regulations⁴⁵ has been loosened in recent years, some of the internationally acting US banks like Citibank are now huge "universal banks" based on the traditional European model, but endowed with the advantages described above and benefiting from their large unified home market. In

addition, some specialised US investment banks like Goldman Sachs or Merrill Lynch are global market leaders in their specific fields. While European universal banks are somewhat hampered to deploy their “universal” strategic assets in China, due to regulative restrictions, US competitors might have an advantage compared to European banks, since they are more flexible to draw on their global experience.

4.3.3 ASEAN Banking Sector Development Trends

The main developmental trends for the ASEAN banking sector are rather difficult to summarise. This is due to the large differences among ASEAN countries in banking sector structures, development, growth, foreign presence and trends (like the changes and implications following the Asian crisis with according long-term impacts on financial sector development) being quite different in each of the ASEAN countries. This is shown for example by the quality of banking assets: NPL rates range between 4% in Singapore, 15.8% in Indonesia and 20.6 % in the Philippines. Except for Singapore, no ASEAN country has sizeable investments in the Chinese financial sector. For the main part, the ASEAN banking sectors still have to struggle with their own restructuring which has still not been accomplished.

Putting aside the distinct character of each market of the ASEAN community, three major development trends might be identified, which potentially pose a threat to European banks competing with ASEAN Banks in China, albeit presumably only on a longer-term basis:

1. In general, ASEAN banks are redirecting their income streams from lending to commercial and industrial customers towards lending to households (e.g. mortgages, consumer loans), and providing fee-based wealth management products. In essence, banks, particularly in East Asia, are in the process of restructuring their balance sheets and transforming their income streams from interest spread to fees, e.g. “selling” investment products instead of collecting deposits and transforming them into loans. European banks, however, are more advanced in this trend, and should therefore be better positioned in this area in China than ASEAN banks.
2. The ASEAN banking sectors has also experienced continuing consolidation trends. The Asian crisis forced governments to intervene and rescue failing banks. Governments then took advantage of this powerful position and

initiated the consolidation of banks into larger groups. Many banks have already consolidated, but bankers and policy-makers in the region continue to identify a gap between the scale economies enjoyed by foreign competitors and their own positions. International banks will probably gain some market shares in local Asian markets. However, so far only a few (mostly Japanese) Asian banks have a well-established and substantial presence in third markets in East Asia.

3. Only a minority of global banks are targeting the domestic currency banking markets in East Asia, seeking the deposits of private banking clients and the upper middle class in order to fund not only business loans but also mortgages, credit card loans and other loans to households. These foreign banks are concentrating on building a wholesale franchise with which they focus on securities activities in the growing local currency debt markets as well as underwriting debt and equity. Developments are going to depend upon liberalisation trends. Countries such as Malaysia, Indonesia and Thailand have introduced capital controls to varying degrees in the wake of the Asian crisis. This is in contrast to the global trend of financial sector liberalisation, which Singapore has followed. The capacity of European and US financial entities to acquire ASEAN based institutions might still exist to some extent, however as ASEAN banks become stronger and more sophisticated, the need for, and possibly the desire for, foreign capital may dwindle.

To sum up, the presence of ASEAN financial companies in China as potential competitors to European or US banks remains of little importance since the bulk of the efforts of ASEAN banks and insurance companies are directed towards restructuring in their home countries.

4.3.4 Global Banking Sectors Compared

When comparing total banking sector assets, the European banking sector is more than ten times larger than the Chinese sector (see **Figure 8**). This also translates into a distinct comparative advantage or strength, given the higher density of EU banking assets to GDP vis-à-vis China. If banking assets to population would be applied, the difference would be even more striking, showing the huge development differential between the European and the Chinese banking sector.

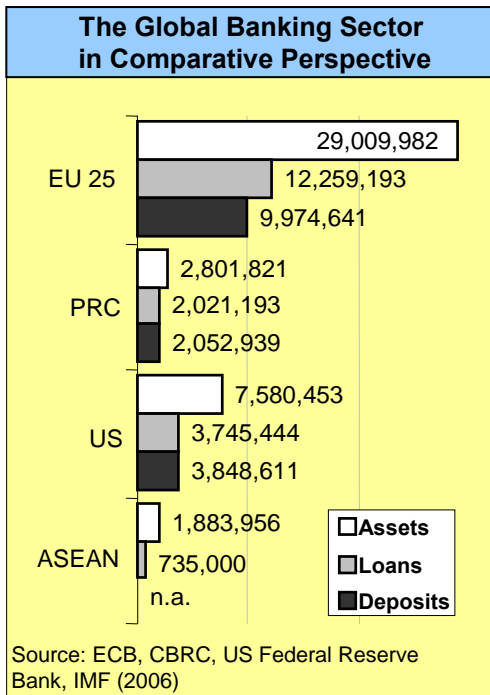


Figure 8: Comparison of World Banking Sectors

The difference between the US and the EU is explained by the fact that they focus their energy on different activities. While European banks rather focus on asset related businesses, such as lending and retail businesses, US banks tend to be engaged in businesses unrelated to assets such as investment banking. Therefore, a larger part of the financial assets in the US economy are

booked with private and institutional (fund) investors, and not in the loan portfolios of banks. The importance of the “classic” financial intermediation function of the banking sector is confirmed by the assets/GDP or the comparable loan/GDP ratios, which show that both in Europe and in China the importance of the banking sector for enterprise finance is about three times higher than financing through capital markets, whereas in the US the latter is much more important. This “traditional similarity” between the European and Chinese banking sectors might benefit European banks in China to establish a competitive position. With regard to the loan to deposit ratios, it shows that China still has some untapped financing possibilities, with deposits and savings kept with the banks and larger loans still being “invested” with enterprises.

5. COMPETITION STRATEGIES IN CHINA’S FINANCIAL MARKETS

5.1 Competitive Strengths and Performance of European and Chinese Financial Institutions

As shown in Figure 9 survey respondents give Chinese financial institutions a high rating in terms of competitiveness within the Chinese market which is, despite increased competition, expected to stay high in five years time.

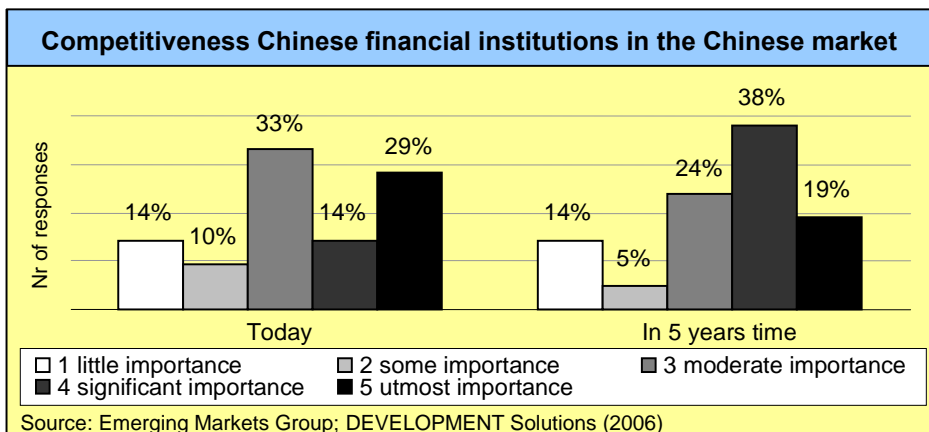


Figure 9: Competitiveness Chinese Financial Institutions in the Chinese Market

Although some of this competitiveness is put down to government support of financial institutions and market intervention, it is also acknowledged that Chinese financial institutions are upgrading their capabilities (see **Figure 10**). Although Chinese banks currently lag behind in product innovations and technology, this is an area in which industry representatives expect Chinese banks to make significant strides in the near future.

A particular strength of Chinese financial institutions is their network coverage. Due to their geographic reach most financial industry representatives taking part in the survey consider it unrealistic to expect foreign banks to dominate the Chinese banking sector, even in a fully liberalised market.

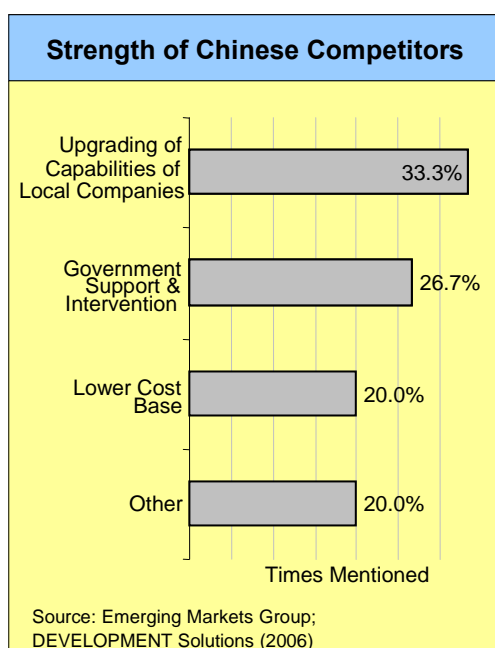


Figure 10: Competitive Strengths Chinese Financial Institutions

It must be noted that around a quarter of interviewees (26.1%) is at pains to point out the cooperative as well as competitive dynamics of operating in the Chinese market, stressing that in many ways the capabilities (and weaknesses) of Chinese and European financial institutions are compatible. In this way, many argue, the capabilities of Chinese financial institutions will on their own and with the help of their respective foreign strategic investors increase, particularly in terms of their service quality and operational abilities.

Figure 11 outlines the main advantages of European financial institutions cited by practitioners. In particular advantages in product innovation, staff expertise and service quality compared to Chinese counterparts are cited. As a result therefore,

European financial institutions generally have the superior product innovation capabilities and financial expertise that Chinese banks need, but lack the distribution network to leverage these⁴⁶.

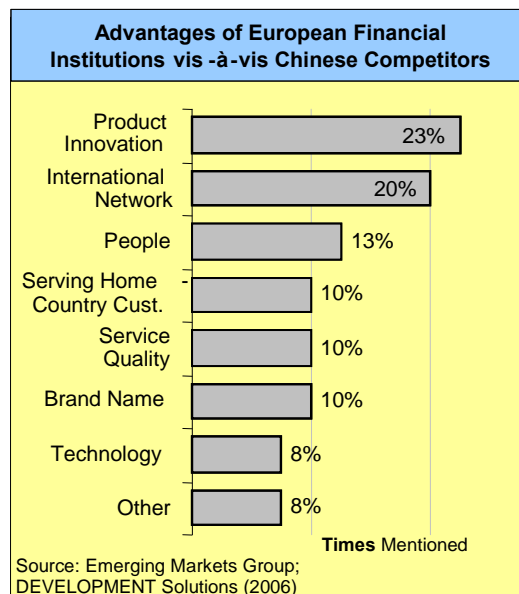


Figure 11: Competitive Advantages of European Financial Institutions in China

At the same time, if the goals of the Chinese government are considered with regard to the internationalisation of the Chinese banking sector in particular, it is important to explore to what extent, as is already apparent in commodities-based sectors, Chinese financial institutions will be seeking access to European markets in future⁴⁷.

Currently the big four Chinese banks have affiliates (mainly branches) in Europe with a combined total assets of around only 10 million USD; mainly in older member countries such as Germany, Luxemburg, UK and the Netherlands. For the moment Chinese banks mainly offer retail business, trade finance and foreign exchange services, primarily to serve their home-country customers, although the ICBC and BOC in London have engaged in investment and security business as well intending to tap into local knowledge networks to accumulate the knowledge and expertise about new businesses and local markets, for instance in the area of SME and retail banking - business which is still underdeveloped in China. As a direct competitor for European clients, however, Chinese banks will not play any role for the foreseeable future. As it is difficult for Chinese banks to set up networks in the EU, Chinese banks might in the future approach the idea of investing into or acquiring local European banks. However, Chinese banks are so far not considered as large global players, with only the ICBC being among the ten

largest banks in the world in terms of assets. Thus, in the foreseeable future, only some limited strategic alliances of Chinese with European banks might be a realistic option in order to tap into their international networks. These significant differences between European and Chinese financial institutions are a key factor in understanding competitive strategies of foreign financial institutions in the Chinese financial sector.

5.1.1 Competitiveness of Foreign Banks in China

Although foreign banks in China can provide only about a third of the total range of financial services available in China, most have realised substantial returns within their first years of operation, cumulatively reaching to approximately 991 million USD. In terms of growth perspective, most foreign banks furthermore predict around 30% annual growth for their own activities, while a few banks even expect to grow by at least 100% by 2008. The rapid increases in returns can be attributed to innovation and the introduction of new banking products and the ability to provide better financial services than those offered by local financial institutions.

However, such success might be of only a short- to mid- term nature. Once Chinese banks accomplish their reforms, and have acquired better banking expertise on a broader scope, partly assisted by their foreign investors, their competitive position might become much stronger in future which could impact on the profitability and growth rates of foreign banks in the long run. Some foreign banks will attempt to increase their economies of scale. However, given the restrictions for foreign banks in achieving larger volumes of business (turnover) combined with a highly competitive environment, an alternative, and perhaps more sustainable approach for foreign banks would be to compete through “differentiation and excellence”.

Box 1: Local Marketing Strategies: VIP Cards in China

Minsheng Bank was very successful in introducing the so-called VIP-Card for selected customers, fulfilling the desire of many customers for branding and recognition. These so called VIP cards (later on copied less successfully by other domestic banks with different features), is clearly targeted at a specific wealthy (or at least those who aspire to be wealthy) clientele. These cards are comparable to “bonus-cards” in Europe provided by larger stores (as a differentiation and client binding strategy), with the difference that these cards provide mainly (at least on first sight) monetary advantages, while the VIP cards provide first and foremost an image, and only then are monetary advantages considered.

The success of these VIP cards seems to prove that there is a potential market for such exclusive products in a country where standardised product strategies are implemented only too often to achieve economies of scale. While the need for standardised economies of scale products might be in higher demand inland, where a predominantly larger low-middle income class is found, affluent customers are highly concentrated, with three-quarters of them living in Beijing and in major coastal cities such as Shanghai and Guangzhou. Foreign banks can easily tap into them despite their limited branch networks. These customers are also willing to change their bank for better and more specific services provided, even if at higher costs.

With an increasing share of enterprises and households requiring differentiated banking services, concentrated in the bigger cities this is a strategy more closely aligned with the strengths and weaknesses of foreign banks. Nonetheless differentiation will be made difficult due to a lack of information security. Some Chinese banks, for example, literally “copy” standardised products and offer loans under the same conditions as foreign owned banks, but do not require collateral in order to poach more clients. Due to the disregard of Chinese banks for adequately valuing risks, foreign competitors’ cannot compete in gaining market share if they apply sound banking practices. A precondition for success therefore is the continuous development of highly innovative, differentiated and even exclusive financial products, targeting the upper level income segments. In this respect foreign banks can learn from Chinese examples of marketing strategies such as that of Minsheng Bank. One such example is the introduction of VIP cards as (see **Box 1**).

5.1.2 Market share and success of foreign banking institutions:

With regard to the overall level of success, thus the market shares of foreigners in the Chinese banking market (2%) are still quite small.

Asian (non-Chinese) banks are active and successful mainly in trade finance, foreign exchange and SME lending. Residential mortgage lending is only offered by one third of Asian banks in China. In the future, their plans rather focus on expansion of the retail area, with only limited focus on large corporate loans. Japanese banks hold about 20% of all foreign banking assets in China and have build up the largest network of institutions and branches in China among all foreign investors, but have not made any investments so far in existing Chinese banks. With regard to ASEAN banks, their very small share (0.22%) of banking sector assets is nearly completely represented by Singapore.

European banks have been successful in trade finance, money markets and foreign exchange, and of course by providing financial advisory services to their “home clients”. Their future plans are more focused on developing their Chinese retail businesses (credit cards, mortgage, deposits and loans). New fields are seen in rather innovative products (for China) such as involvement in asset management, debt swaps to sell bad loans and SME financing, and also in operations outside the largest cities. Larger European banks have pursued a two-tiered strategy of both setting up their own subsidiaries and investing into existing Chinese banks. Generally there is a relatively large number of European banks active in China, especially compared to their US counterparts.

US banks: US and European competitors have comparable shares in terms of volume (each group estimated at between 35 and 40% of all foreign banking assets in China). US institutions concentrate on only a few large global players such as Citibank, Bank of America and Goldman Sachs. Trade finance and money markets have also been the most successful fields for US banks in China. Also some positive results by a few of them were recorded in other product areas such as fund management, internet banking, transaction services, SME banking, treasury or retail deposits. US banks rather tend to assign a “universal” approach, thus assign importance to each product rather than focus on specific products. To them, seemingly, the retail market is of inferior importance albeit covered also. Like European banks, they have invested into existing Chinese banks and set up operations of their own in China.

5.2 Competitive Strategies in the Chinese Banking Sector

Although many European financial institutions would prefer to operate through branches or strategic investments in domestic banks, a majority of industry participants surveyed intend to increase their market presence through organic growth, setting up their own network of wholly owned branches (**Figure 12**). However, for larger financial institutions a ‘two-tiered approach’, serving mainly corporate customers through their branch network while accessing Chinese retail customers through their stake in a Chinese financial institution (particularly a joint stock commercial bank) is a common strategy. For some, owning a stake in a Chinese financial institution is primarily intended to distribute financial products such as insurance or credit cards.

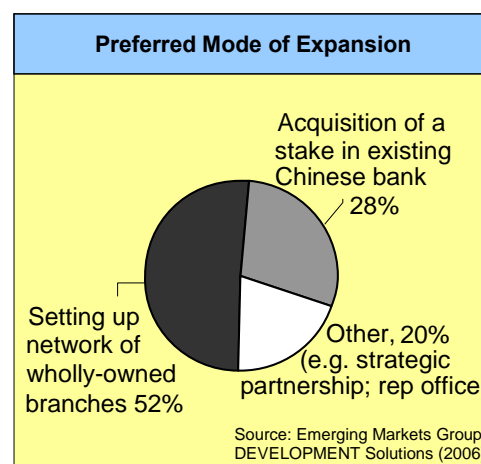


Figure 12: Preferred Mode of Expansion European Financial Institutions in the Chinese Market

5.2.1 Organic Growth

With organic growth, the creation of wholly owned branch networks is likely to be a critical component of the China-strategy of foreign companies, in particular foreign financial institutions reaching out for local-currency deposits and RMB-denominated credit cards, mortgages or other personal lending products following deregulation. Branch networks will then provide the platform for customer access and brand building. Leading foreign banking groups such as Citibank and HSBC are building their own branch networks in central locations already (for instance, in the Bund and Pudong financial districts in Shanghai but also in Beijing), on the look-out for higher end customers. The same accounts for insurance companies, which will then have the right to market other products, such as life insurance and mutual funds.

5.2.2 Investment in Chinese Banks and European operational strategies

Partnership with Chinese institutions will probably be necessary for foreign banks that wish to compete for the larger segments of the market in the future, particularly the masses of lower-medium income. Since most product markets are de facto still closed to foreign investors, such an alliance is the only way to get in early, become acclimated to local conditions, and master the skills needed for success. Furthermore, if the government should ever alter its regulatory agenda and attempt to limit the expansion of foreign banks, partnerships are less likely to be affected. With them in place, foreign institutions can pounce if opportunities arise early and stay ahead of the curve if the markets develop. A crucial development in this respect will be whether future liberalisation will give foreign investors the ability to exercise management control and to protect investors’ rights.

Particular areas of cooperation might be syndicated loans (or loan swaps, to decentralise risks), cooperation in trade finance, factoring and forfeiting (knowledge on the European side) and cooperation in RMB business (knowledge on Chinese side). Despite the fact that foreign banks are practically prevented from assuming a large role in the RMB business also in the future (see above), if they are to participate to any significant degree, they have to develop this business step by step in order to get a stronger refinancing base and a larger customer base - if need be with Chinese partners. Such opportunities should exist for foreign banks in principle, since they have – as foreign institutions – a potentially very good reputation with clients. Inevitably many Chinese banks will have to be closed or go through a consolidation process, something the Chinese government is probably even aware of. To what extent foreign banks will be involved in this consolidation process is a more open question. But if a consolidation process in the Chinese banking market should take place, foreign institutions with their international reputations are likely to come out as the overall winners in terms of market share.

Compared with the big four banks, the smaller commercial banks have better asset quality, but still relevant networks, particularly in the major coastal cities and allowing for good business development expectations. When considering an acquisition, publicly listed banks have advantages since they will enable foreign banks to raise funds in Chinese security markets, and provide for a possible exit option via the secondary market. A major reason for a Chinese and a foreign banks to cooperate is seen in their different, respective strengths and weaknesses. Chinese banks are likely to have a more profound knowledge of clients and their demand, and better distribution channels in an, as of yet, not fully functioning financial market. Additionally, they have gained experience in obtaining information on clients despite the absence of well-developed information channels. Today it is possible to conclude several loans with different banks by providing only one piece of collateral. This is, despite the establishment of the CRCS, a credit information system. The system, however, can only be as good as the bank's ability to bring in reliable information (where gaps seemingly persist). Foreign banks find it harder to operate under such circumstance, since their systems depend on formal information channels. On the other hand, foreign banks hold the necessary know-how and experience in credit and risk management, corporate governance or

auditing and in innovative products such as derivatives, hedge products or securitisation, the Chinese partners often still lack.

Most foreign banks initially focused on “follow the customer strategy”, partly because regulatory restrictions did not leave much choice. Since bilateral trade and investment of international companies increased with the establishment of foreign-owned plants in China, international banks have sought to maintain their relationship with their home country customers by providing them with financial services. This strategy might have to change when tapping into the domestic client sector as deregulation permits.

In terms of product strategy, foreign banks mainly use their competitive advantage in providing universal financial operational models (in an attempt to circumvent legislative restrictions), and primarily service their home-country customers. For example, European banks (through their parent holding companies) are able to offer insurance and investment products either through their Chinese units or by “passing on” products from their head office in home countries: Allianz intends to distribute insurance through Dresdner Bank's stake in the ICBC, while similar to ING intends to distribute its insurance and ING Direct saving products through Bank of Beijing.

5.2.3 Asset Management Opportunities

One important area where foreign banks could apply their skills in assisting China's banking sector reform without directly investing into Chinese banks is the structuring and trading of problematic loan portfolios (bad loan securitisation), thus replacing the state-led Asset Management Companies (AMCs) with a market-based approach. Chinese policy will support internationalisation of Chinese bad debts, not only through increasing foreign shareholding in Chinese banks but also through having bad debt sold on at a discount in international capital markets (e.g. to hedge funds with an appetite for such risks).

5.3 Competitive Strategies in the Chinese Insurance Sector

Until recently, the non-life market has been severely restricted for foreign companies, with the result that major market strategies could not be developed, for instance with regards to geographical deployment. In future, the market will seem formally almost unrestricted, offering a broad range of alternative strategies, with seemingly considerable scope for launching new products. To what extent regulations not directly (but indirectly) affecting the insurance sector, or a lack of adequate

regulations, will hinder foreign providers from product innovation remains to be seen. The issue for foreign companies is whether to pursue a comprehensive product strategy, one more focused on market niches, or a mix of both. However, the most important retail product for non-life insurers, that being third party motor liability insurance, remains closed to foreign participation.

In the life sector, the same choice must in principle be made. In years to come there should be considerably more scope – perhaps necessary for competition – for a "niche" product approach. Pension and health-related products are expected to be a major area of new opportunities and competition in the future. At present, however, it seems that just like in the non-life sector, indirect regulation or a lack of regulatory procedures hinder product development for foreign institutions, while a lack of information security means that differentiated products are quickly copied. In general, niche approaches in the future are expected to be the most effective way to take advantage of expected opportunities. Foreign institutions have routinely targeted the high income earning segment. Competitive pressure and opportunities for rapid growth are strong arguments in favour of efforts to develop the middle and even low income segments. Such development will however require changes in distribution strategy.

The individual agent method of distributing life insurance has been reasonably successful for market leaders, but its high costs inevitably restrict it to serving customers in the top earnings bracket. Companies that find a cheap and effective distribution model in China – and thereby able to adopt a more broad-based market strategy – could reap substantial benefits. Again, the strategies chosen by ING and Allianz, who intend to distribute their insurance products through the bank branches of Bank of Beijing and ICBC shows a creative "two-tiered approach" that large international investors can adopt to bypass restrictive legislation. At the same time, Allianz and ING also both set up their own non-life insurance company and also participate in life-insurance joint ventures. Most likely, a successful model will be one that is developed locally and that is adapted to "Chinese market characteristics". Opportunities are seen for expanding in China through alliances and even assuming full ownership of a life-insurance company. Although this has so far only been achieved by AIG (based on a historic first mover advantage), foreign companies with a long-term strategic perspective should begin to position themselves to take advantage of these opportunities.

With regard to the competitive position of Chinese insurers in the European insurance market, it seems even less likely than in the banking sector that Chinese players will play any role in Europe, since the Chinese sector itself is still largely underdeveloped. At present, no Chinese insurance companies would even have the required liquidity to take a major investment in any of the larger European companies. The only major field where additional Chinese activities should be expected is with an Export Credit and Insurance Agency (ECA) to support the growing Chinese manufacturing industry in its export business. A very specific task for EU policy, together with other OECD members, therefore will be to ensure that Chinese export finance and export insurance abide to the same rules that OECD members follow, and in particular not unduly support Chinese exports through highly subsidised finance in third markets. Such subsidised finance, promoting Chinese exports in manufacturing both in Asia but also increasingly in the resource sectors of Africa, with the strategic aim of getting Chinese control over natural resources, is already an important phenomenon. But since the "business field" of state-led export finance and insurance is a domain of governmental actors and state-based companies (e.g. ECAs) throughout the world, it shall not be further elaborated in this study.

Notwithstanding the seemingly successful competition strategies applied by foreign competitors in the banking and insurance market, future levels of success will largely depend on adopting tailored strategies for the Chinese market, but also on foreign competitors' ability to cope with the systemic risks which remain an ever-present threat to their Chinese operations. Strategies will also be shaped by the effective degree of liberalisation of the financial sector, or in other words, the extent to which promises on paper are fulfilled or new, informal barriers, are to be set up. The relatively more aggressive approach toward restructuring currently being implemented can largely be seen as a result of good economic growth. The agenda for further financial sector liberalisation will be balanced against the government's social and political agenda, which is likely to result in a measured approach. Critically, the government is still a major shareholder in both the banking and insurance sector, and there are no convincing indications that it plans to relinquish its controlling stakes in the country's major banks and insurance companies in the near future. This is something that will continue to hamper free and fair competition from the first instance. Even if there are some signs that the state is relinquishing some of its

direct control on the financial sector, the state will and arguably to some extent should, directly or indirectly maintain some degree of influence and controls in place. The large strides taken so far toward improving the financial health of the sector mainly include government capital injections into state-owned commercial banks, regulatory reforms, and attempts to instil a commercially oriented management culture. In addition, the authorities have allowed the entry of foreign strategic investors, which are expected to set standards of best practice and introduce expertise, hopefully until the market will be ready for competition. Others have argued however, that until foreign financial

institutions are allowed to take a controlling stake, Chinese financial institutions do not have adequate incentives to improve their financial performance. The recent huge and highly visible Initial Public Offerings (IPOs) made by Chinese banks only involved the flotation of minority stakes to foreign investors, and arguably do not impact enough on the banks corporate governance structure.

5.4 SWOT Analysis European and Chinese Financial Sector

A summarised analysis of the strengths, weaknesses, opportunities and threats of the European and Chinese financial industry is outlined in **Table 6**:

Table 6: SWOT Analysis of European and Chinese Financial Sector

| Europe | China |
|---|---|
| <p><i>Strengths</i></p> <ul style="list-style-type: none"> -International network and experience (many European banks serve Chinese customers investing abroad) -Existing customer base and understanding of customer needs (e.g. EU corporate customers investing in China) -Superior service quality, branding; better management and technology - Foreign currency lending, good credit rating - Asset-liability management; Sophisticated products | <p><i>Strengths</i></p> <ul style="list-style-type: none"> - Protective Legislation - Government bail-outs - Extensive branch network -Technology: Rapidly catching up due to large investment in technology. Increases capabilities which opens up new product possibilities (e.g. CCB in payment & receivables system; China Merchant Bank in credit cards) |
| <p><i>Weaknesses</i></p> <ul style="list-style-type: none"> - Limited branch network | <p><i>Weaknesses</i></p> <ul style="list-style-type: none"> -Inefficient conversion of financial resources into productive investment: majority of resources continue to be channelled towards inefficient SOEs. - Technically insolvent |
| <p><i>Opportunities</i></p> <ul style="list-style-type: none"> - 1.3 Billion customers with a national savings rate of 47.6% GDP - Experience of new products, credit cards etc. - Some financial industry practitioners are at pains to point out the cooperative as well as competitive dynamics of operating in the Chinese market. -Electronic banking might to some extent off-set branching restrictions. | <p><i>Opportunities</i></p> <ul style="list-style-type: none"> - 47.6% national savings rate in GDP (scope to transfer from banking deposits to insurance products) - Continued financial and institutional reform: Chinese companies to reform (e.g. IPO Chinese banks; Trading of LP-shares) - Chinese banks and their respective foreign strategic investors increase their service quality and operational abilities. - Complementary Chinese and EU sectors: Chinese distribution networks, European financial institutions have an advantage in product innovation and financial expertise. - Increasing foreign currency reserves |
| <p><i>Threats</i></p> <ul style="list-style-type: none"> - 4 SCB have a share of nearly 60% in overall deposits. Market access restrictions tapping into this large savings pool will be a major challenge to foreign banks - Limited scope for leveraging expertise in product differentiation. Licenses required for product innovation, regulatory restrictions on risk premiums - Market restrictions and obstacles - Too many banks chasing too few viable customers | <p><i>Threats</i></p> <ul style="list-style-type: none"> - A moderate rise in interest rates or a moderate drop in sales could cause 40% -60% of the debts of all firms to become unserviceable, a problem which banks have to face. - Underdeveloped capital markets limit scope for financial intermediation. Market cap is just \$447.7 billion, with about 1,378 or 71.6% SOEs. 2/3 of shares are not tradable, and among the tradable shares, 2/3 are state controlled. -Institutional weaknesses- as many representatives comment, Chinese banks still need to solve many of their more serious governance problems. |

6. SCENARIOS AND FUTURE POTENTIAL FOR THE EUROPEAN FINANCIAL SECTOR IN CHINA

Two scenarios are given for the possible development of the banking and insurance markets in China over the next 5 years, and for the respective market shares European banks and insurance companies could gain. Obviously, such scenarios strongly depend on underlying assumptions, which, even if well set, can only give a very simplified picture of the future possible development. Thus, scenarios should not be considered as "prophecies" on how the banking and insurance markets in China and the respective market shares of European banks and insurance companies therein develop. Rather, such scenarios can be used to identify key variables, which might determine the future development of the Chinese financial sector.

The two scenarios developed here constitute:

1. A baseline scenario, thus a nominal prediction of future developments, one in which restrictions for market access of European operators are expected to largely remain in place even after 2006⁴⁸ and;
2. An optimistic scenario, in which such regulatory or practical restrictions for European operators are removed.

Other Assumptions:

Apart from the developmental course of the legislative environment and irrespective of the question of what market-share European operators can capture, an important variable for designing such scenarios is the assumptions made concerning the growth-rate of the banking and insurance markets in China. In order to simplify the exercise and work out more clearly the "baseline" and the "optimistic" case, it has been decided to combine both relevant variables. Thus, the more pessimistic "baseline scenario" combines remaining restrictions for European operators with the assumption that the banking and insurance markets in China in general only grow moderately.⁴⁹ On the other hand, in the "optimistic scenario" a combination of unrestricted market access of European operators together with

assumptions for a very strong market growth in general has been modelled⁵⁰. In the same line of thinking the more restrictive baseline scenario is accompanied by lower (but still significant) economic growth, whereas the optimistic scenario is accompanied by even higher GDP growth rates, since here the liberalised market forces come into play.

A "worst case scenario", i.e. a scenario in which Chinese economic growth collapses, and thus banking and insurance markets collapse as well, has not been modelled. This is because at present there is no reason to believe that China's further economic development should fail and, even if economic development should fail, it would become difficult to model scenarios for European banks and insurance companies' development in such a situation, due to a wide range of "unknowns" and stochastic variables.

6.1 Baseline Scenario (-2010): Moderate Growth of Banking and Insurance Sector, with Limited Access for European Operators; Conservative Assumption of GDP Growth

6.1.1 Assumptions

GDP

- GDP: growth 6% p.a.
 - o 2004: 1,218 billion EUR, 2010: 1,728 billion EUR

Banking Sector (total in China):

- Banking assets: growth 8% p.a.
 - o 2004: 2,800 billion EUR, 2010: 4,400 billion EUR
- Bank loan growth 8% p.a.
 - o 2004: 2,000 billion EUR, 2010: 3,200 billion EUR
- Bank deposit⁵¹ growth: 6% p.a.
 - o 2004: 2,000 billion EUR, 2010: 2,800 billion EUR

Insurance Premiums (total in China):

- Non-Life premiums growth 12% p.a.
 - o 2004: 11 billion EUR, 2010: 22 billion EUR
- Life premiums growth 15% p.a.
 - o 2005: 38 billion EUR, 2010: 76 billion EUR

Table 7: Baseline Scenario Assumptions

| | Bank Assets / GDP | Loans / GDP | Deposits / GDP | Insurance Premiums / GDP |
|------------|--------------------------|--------------------|-----------------------|---------------------------------|
| China 2004 | 230% | 164% | 164% | 3.6% |
| China 2010 | 255% | 185% | 162% | 5.7% |
| EU 2004 | 280% | 118% | 96% | 8.3% |

In the baseline scenario, China's banking and insurance markets in 2010 are still expected to be less developed (in terms of assets and premiums to GDP) than EU markets were in 2004. The current higher ratios of loans and deposits to GDP in China are explained by the fact that there are few alternative forms of investment for individuals, something which is expected to improve somewhat under the baseline scenario. See **Table 7** for a summary of baseline scenario assumptions.

6.1.2 Development of Market Shares of European Operators (in Baseline Scenario)

Banking sector:

Current "average" ⁵² market share of European banks of 0.8%⁵³. Due to effectively limited market access, the share of European banks in the Chinese market is expected to only grow to an average of 3.5%⁵⁴ market share by 2010.

Insurance Sector:

Non-Life: current market share of European operators is at roughly 0.4%. Due to effectively limited market access, the share of European banks in the Chinese market is expected to grow only to 5% market share by 2010.

Life: current market share of European operators is at roughly 0.8%. Due to practical limitations on market access, the share of European banks in the Chinese market is expected to only grow to 8% market share by 2010.

6.1.3 Specific Expected Sub-Sector Results in Baseline Scenario

Fully foreign-owned banks will not be in a position to significantly expand their branch networks (too costly and slow given the de facto restrictive regulatory environment). This will impede them in building up both a broad customer outreach (in the provinces) and a broad RMB refinancing base (from deposits). Deprived from these basic growth factors, stand-alone foreign banks will not gain any significant foothold in the following market segments:

- RMB lending: no access towards provincial enterprises, and no comparative advantage in comparison with Chinese banks in large cities (due to lacking refinancing base of European banks);
- Retail Banking: no country-wide branch presence will make foreign banks unattractive for retail clients. They cannot access their bank locally; intra-Chinese payments (e.g. for children studying in large cities, or remittances to parents) are costly since third banks must be involved. Thus, also more sophisticated financial

products for the mass of Chinese potential clients like mortgage loans or savings and pension products will remain out of reach for stand-alone foreign banks. The seemingly giant market of 1.3 billion potential customers, where expectations are that the number of Chinese with an income above USD 3,000 will increase tenfold between 2005 and 2015, will largely remain inaccessible for foreign banks.

Foreign banks could therefore only participate through their shareholdings in Chinese banks; but here they cannot gain controlling stakes (forbidden by regulation). Here, foreign participation serves mainly as a source of capital and in particular management know-how for reforming Chinese banks. It is expected in this baseline scenario that the profitability of these minority participations of foreign banks remains low, since majority shareholders (Chinese) manage to retain and "internalize" profits: As long as management control rests with dominant Chinese shareholders, they have an incentive to find ways to reduce "formal profits" (e.g. by pricing the bank's services to their own companies somewhat cheaper) or to ensure that profits are retained and cannot be paid out to the foreign or other minority investors. After such a frustrating development – barring a few minor exceptions – foreign banks in this scenario are not expected to launch a new large wave of banking sector investments in China, after the current "hype" is over.

A strong indication that investment into a large Chinese bank might not reap the rewards some might expect is given by the investment behaviour of Citibank and HSBC. Both are among the world's largest banking groups and with considerable experience in China, they nevertheless choose to play the game more carefully than some others. Citigroup has only invested a small stake in the mid-sized provincial Guangdong Development Bank (GDB) in 2003, but has since undertaken to lead a consortium of investors in an attempt to acquire an 85% majority stake in the GDB worth roughly USD 3 billion, plus some USD 6 billion additional funds to cover for bad loans. Societe Generale of France competed, again in a consortium, with a similar offer. End of July 2006, however, both consortiums had to readjust their structure, taking on board strong Chinese partners, since the authorities don't seem to waive the regulation that foreigners cannot hold more than 25% in a Chinese bank. HSBC, which has bought a 19.9% stake in Bank of Communications (BOCOM) and seems to be on a similar footing. Although BOCOM is currently the fifth largest bank in China, it is five times smaller

than the largest, ICBC. Likewise, Deutsche Bank has positioned itself with a 14% stake in the mid-sized HuaXia Bank. The strategies behind these approaches, however, are based on the hope that sooner or later the Chinese authorities will allow these foreign investors to gain controlling stakes in these banks above the current upper limit of 25%. In this “baseline scenario” it is assumed, however, that such waivers will not be granted, and that the Chinese authorities nevertheless manage to keep strong interest from new foreign investors for Chinese banks, although sooner or later the plans of those investors who hoped for a majority stake would inevitably be frustrated.

Despite the rather pessimistic baseline scenario in which market entry limitations currently in place persist, there are expected specific business fields, which show more positive perspectives for European banks to gain a strong market foothold:

- SME lending: despite the dominance of Chinese banks in corporate lending, which is expected to prevail, the SME-financing segment offers opportunities for European banks for two main reasons: (1) European banks traditionally are active in this field and have significant experience, while Chinese banks traditionally are not active in this field. (2) When diversifying their predominantly corporate (mainly SOE) lending, it is expected that most Chinese banks will focus on simple and mass-based retail business with private customers, and thus leave room for foreign (in particular European) players in the more complex field of SME lending. This field requires a well-developed credit analysis and risk management capability. Without a China-wide branch network, however, such SME lending will mainly take place in and around the large commercial cities where European banks are present.
- Trade Finance: with the increasingly important role of China as a trading-partner in the world economy (China already accounts for about 7% of international trade), the demand for trade finance will grow. However, in the baseline scenario, which is nominally conservative regarding the further progress of banking reform in China, risks and associated risk pricing will hamper the development in this business field. If European banks consider engagement with Chinese banks still too risky, they will limit the trade finance credit lines offered to them for prudential reasons, or request high collateral (e.g. cash deposits). Resulting

higher prices of trade finance will thus again diminish effective demand.

- Fund and asset management: despite limitations in setting-up branch networks, there is a good chance that European banks will enjoy better access to the segment of wealthy individuals and will be able to offer fund and asset management products. These customers are mainly located in larger cities (where European banks are also present) and are willing to pay for better services, reputation and international contacts. European banks, however, will face fierce competition from US banks in this specific segment who will probably be even more successful here, based on their larger and more sophisticated experience with fund and asset management in their home market.
- (Innovative) Transaction banking: despite obstacles due to their small branch networks, European banks could capture larger segments of inner-Chinese transaction banking, if they manage to successfully apply their superior knowledge and technology in e-banking, and if they get the respective approvals of the Chinese regulators. Indeed, the Chinese regulator CRBC might be quite receptive to opening up this specific field, since the regulator has a strong interest in the implementation of “secure” technologies. In seeking the best technical solutions, they might be open to extensive foreign participation instead of protecting Chinese banks with their less sophisticated technologies and lower safety standards.

Despite high expectations among many foreign market participants it is not expected that foreign banks will get a strong foothold in the RMB loan and deposit business. The credit card business in this scenario can only be developed in close cooperation with Chinese banks, since they can offer credit cards at lower costs than international providers, mainly because they would employ lower technical and safety standards and are already very successful in marketing their cards. Therefore, it can be assumed that any profits in such joint credit cards business will mainly end up in the pockets of Chinese partners and not with the European banks.

The baseline scenario, despite remaining restrictions, foresees a total future market share of European banks (measured in share in total banking sector assets in China) of 3.5% or 154 billion EUR, as compared to the current 0.8% or 22 billion EUR.

Insurance Sector:

The non-life insurance sector is the most open sector among the three sectors considered (banking, life/ health insurance

and non-life). There are no indications that the authorities will restrict it further, even in this relatively pessimistic “baseline scenario”. There are only two relevant “restrictions” in this field for European operators. For private insurance policies, the “bread and butter” business of motor vehicle third party insurance is not yet open for foreigners. The official justification for this probably lies in the official or “quasi-sovereign” character of motor vehicle registration, which apparently justifies the preference for local insurers or even state-owned Chinese insurance companies. The second impediment is economic and transition-related: a large share of Chinese enterprise buying industrial insurance are still SOEs or somehow connected to the state, and will therefore likely favour (or be induced to favour) Chinese or even “official” suppliers of insurance.

Apart from these constraints there seems to be no major obstacles for European providers to gain a foothold in the non-life insurance market. Indeed, in the non-life sector, almost all foreign investments were made into fully foreign-owned subsidiaries and not into joint ventures with Chinese partners. Just like their Chinese counterparts, European insurance companies operating in China will be able to set up their branch networks and distribution channels with insurance agents. Thus, even in the pessimistic scenario, they are expected to gain a fairly significant market share of 5% by 2010 (or 1.1 billion EUR), from their current share of 0.4% (or 44 million EUR).

The life insurance sector is still very strictly regulated with foreigners entitled only to minority investments in Chinese companies, or limited to building-up joint ventures (up to 50% ownership) with Chinese partners. Given the political sensitivity of the life and health insurance sectors as a means to replace the social security network formerly often provided by SOEs (“the iron rice bowl”), it is expected in the baseline scenario that restrictions for foreigners will remain in place and be justified by the Chinese government on the basis of this high degree of “political sensitivity”. So far, three Chinese life insurance companies dominate the market with a share in premiums of 83%, only one of which has a foreign investor, HSBC, holding a significant share of 19.9%. It is assumed in this somewhat pessimistic scenario that restrictions will not be reduced for foreign

life-insurers, nor will they be allowed to obtain any controlling stakes in any Chinese life insurance providers. Therefore, despite the rapid growth of 15% p.a. expected for the life-insurance sector even for this “baseline scenario”, the achievable market share of European providers is considered at only 8% by 2010. Additionally, all this “market share” will be based on investments with Chinese companies or in joint-ventures, and therefore it can be assumed that European investors will have problems in sharing significant profits from these investments, since they will usually not hold control of the enterprises. Nevertheless, given the expected huge growth of the market in general, European insurers even in this “baseline scenario” are expected to gain a market share of 8% by 2010 (currently 0.8%), which could be worth 6 billion EUR in annual premiums (currently 300 million EUR).

6.1.4 Profitability Assessment

Despite the baseline assumptions predictions regarding the growth of the banking and insurance markets are more conservative than the generally bullish sentiment in the industry. The scenario still projects high market volumes for European (as well as other international) banks and insurance companies in China. With regard to profitability of such investments, however, the following additional qualitative remarks should be made:

In this scenario it is assumed that Chinese authorities successfully manage the high expectations of foreign investors in order to help improve the performance of China’s financial industry, while at the same time ensuring that foreign operators will on average be only able to make marginal profits from their ventures. In essence, foreigners will then continue to invest in the pursuit of high profits in this theoretically huge market, but these expectations for the majority of investors will not materialise - something which some European institutions surveyed have already indicated. The key part of this Chinese policy is to steer foreign investments into banks and insurance companies in which the Chinese partners will retain control, including over how profits are distributed, while fully foreign-owned banks and insurance companies will either be prevented from operating, or if they operate, do so under restrictive conditions.

Table 8: Baseline Scenario Summarised Results

| € (bn) | CN Banking Sector | | | CN Life Insurance | | | CN Non-Life Insurance | | |
|--------|-------------------|-----------|-----------------|-------------------|-------------|-----------------|-----------------------|-------------|-----------------|
| | CN Assets | EU Assets | Market Share EU | Total Premiums | EU Premiums | Market Share EU | Total Premiums | EU Premiums | Market Share EU |
| 2004 | 2,800 | 22 | 0.8% | 33 | 0.3 | 0.8% | 11 | 0.044 | 0.4% |
| 2010 | 4,400 | 154 | 3.5% | 76 | 6 | 8% | 22 | 1.1 | 5% |

Table 9 Optimist Scenario Assumptions

| | Bank Assets / GDP | Loans / GDP | Deposits / GDP | Insurance Premiums / GDP |
|------------|-------------------|-------------|----------------|--------------------------|
| China 2004 | 230% | 164% | 164% | 3.6% |
| China 2010 | 271% | 193% | 164% | 8.6% |
| EU 2004 | 280% | 118% | 96% | 8.3% |

**6.2 Optimistic Scenario (-2010):
Strong Growth of Banking and Insurance Sector, with Open Access for European Operators; Assumption of Strong Economic Growth**

6.2.1 Assumptions

GDP

- GDP: growth 9% p.a.
 - o 2004: 1,218 billion EUR, 2010: 2,042 billion EUR

Banking Sector (total in China):

- Banking assets: growth 12% p.a.
 - o 2004: 2,800 billion EUR, 2010: 5,527 billion EUR
- Bank loan growth 12% p.a.
 - o 2004: 2,000 billion EUR, 2010: 3,948 billion EUR
- Bank deposit growth: 9% p.a.
 - o 2004: 2,000 billion EUR, 2010: 3,354 billion EUR⁵⁵

Insurance Premiums (total in China):

- Non-Life premiums growth 15% p.a.
 - o 2004: 11 billion EUR, 2010: 25 billion EUR
- Life premiums growth 32% p.a.
 - o 2005: 38 billion EUR, 2010: 150 billion EUR

In the optimistic scenario, China's **banking market** in 2010 is expected to have reached the level of development (in terms of assets to GDP) that EU markets had in 2004. The fact that loan/GDP ratio in China (2010) is estimated higher than in EU (2004) is due to the fact that other financial assets (bonds, shares) are assumed to still play a smaller role. Similarly, the projected higher share of Chinese banking deposits to GDP, indicate the possibility that there will still be a lack of alternative investment products available. The Chinese **insurance market** in this optimistic scenario is expected to have gained a similar market penetration level (premiums/GDP ratio) by 2010 to that which was achieved in the EU by 2004. See **Table 9** for a summary of optimistic scenario assumptions.

6.2.2 Development of Market Shares of European Operators (in Optimistic Scenario)

Banking sector:

Current "average" market share of European banks of 0.8%. Under the assumptions of the

optimistic scenario, the removal of remaining "practical" market access barriers after 2006, especially in the fields of branching (easier licensing, consolidated accounting) and thus better access to RMB deposits, the share of European banks in the Chinese market is expected to grow to a market share of 6% by 2010.

Insurance Sector:

Non-Life: current market share of European operators is at roughly 0.4%. Under two assumptions differing from the more pessimistic "baseline scenario" – market opening for third party motor liability insurance and quick transformation of insurance-seeking SOEs into privately managed companies who contract with the best insurance provider – it is estimated that European insurance providers could gain market shares of up to 10% by 2010.

Life: current market share of European operators is roughly at 0.8%. If European insurance providers are permitted to operate fully foreign-owned companies they could leverage their full comparative advantage (know-how, global fund management) and could even gain a market share of around 12% by 2010.

6.2.3 Specific Expected Sub-Sector Results in Optimistic Scenario

Banking sector

Although it will still take considerable time and up-front investment, fully foreign-owned banks will be in a much better position to significantly expand their branch networks as compared to the more pessimistic "baseline scenario". Given that they would first concentrate on expanding to the many very large cities still un-served in China's inland areas, they could, at least theoretically with only a few additional branches (and supported by e-banking tools), gain quick access to a large additional base of RMB clients.

Under such conditions, European banks, either directly or through their investments in Chinese banks, would be able to get a significant foothold on the RMB deposit market and, with a larger branch network, the RMB lending market. The main growth areas would probably lie in and around large cities in inner China, with loan customers being large SMEs, corporations and, possibly, even some SOEs. Whereas such developments would automatically also bring in deposit clients (and thus RMB refinancing possibilities) to European and other foreign

banks, loan clients would still have to be found. The Chinese banks would still continue, even in this scenario, to provide cheap and somewhat “forgiving” credit to SOEs and large corporations, but the vibrant and healthy SME sector, which the Chinese banks rarely target, would become available for loans from European banks. In addition to that, deposit clients would also increasingly become loan clients through cross-selling effects (e.g. mortgage or education loans).

Only with a significantly increased branch network - thus even greater long-term commitment and up-front investments - would European banks also be able to get a stronger foothold in other fields of retail banking (e.g. transaction banking within China) and this effect should rather be expected towards the end of the period analysed. However, even under this scenario, Chinese banks will remain the dominant in this area.

This optimistic scenario thus indeed builds on the idea of a mass market of 1.3 billion potential customers materialising, becoming increasingly wealthy (some estimations predict that the number of Chinese with income of over USD 3,000 p.a. will increase tenfold by 2015), and thereby developing demand for all sorts of banking products. Another very important aspect in this scenario concerns the role European banks could play as investors in, and with Chinese banks. If European banks can, without practical impediments, build up their own branch network and thus fully access the RMB markets, they would also be in an improved negotiation position towards Chinese banks when it comes to investment. If European banks have the “real alternative” of going it alone in China, they can negotiate better terms when investing in/ with Chinese banks and, eventually, the government might even agree that foreigners may take majority positions in Chinese banks. The well-known phenomenon that profits in Sino-foreign Joint Ventures often seem to fall mainly to the Chinese partner would change under these conditions. In the long-run, of course, this would also be advantageous for the Chinese side, since the inflow of foreign direct investment into the banking and other sectors would maintain, or even increase its current high levels, thereby constantly bringing in new capital, know-how and international market access. The already high stakes some European banks have acquired in mid-sized Chinese banks – HSBC’s 19.9% in Bank of Communications, ING’s 19.9% in Bank of Beijing, BNP’s 20% stake in Nanjing City Commercial Bank ⁵⁶, Standard Chartered’s 20% stake in Bohai Bank or Deutsche Bank’s 14% stake in Hua Xia Bank - could be signs for several European banks

are betting on such an optimistic scenario under which they could become majority shareholders in Chinese banks at some stage in the future. The investment of Newbridge Capital (US) with their 17.9% stake in Shenzhen Development Bank probably follows the same strategy with great success; since most of the other A-shares of this bank are widely dispersed, Newbridge already has a significant level of control here.⁵⁷

With both fully foreign-owned banks and the possibility to partner with Chinese banks on even terms, European banks would be able to increase their share of the market in virtually all segments, except possibly in providing financial services for SOEs or other state-related institutions. Additionally, European banks would enjoy an even more positive market outlook in SME lending, trade finance, innovative transaction banking and, despite being less likely to be successful than US banks, fund and asset management.

Under the optimistic scenario, the following business fields are expected to be the most promising for European banks:

- Credit Cards: unsurprisingly, in a status-oriented society and a quickly growing, consumption-led economy, credit cards are a huge growth area. European banks would profit from this field mainly through their participation in Chinese banks, with their larger networks and cheaper credit card technology.
- Consumer loans (in particular mortgage loans): could be issued both by fully foreign-owned banks and JVs in larger scale.
- Securities trading: it is assumed under this optimistic scenario, that also the capital markets will be further developed. European banks could play a very significant role, not only by arranging and trading securities (shares, bonds) for corporations, but also in the specific field of structuring and trading bad loan portfolios.
- Last but not least, as the basis for many potential business fields, European banks could attract a significant part of the RMB retail deposit market.

Under the optimistic scenario it is thus assumed that European banks operating in China can increase their market share (measure as share in total banking sector assets) from currently around 0.8% or 22 billion EUR to 6% or 330 billion EUR.

Insurance Sector

In the non-life insurance sector, the only notable restriction still in place by end 2006 (that being on third party motor liability insurance) is assumed to be removed as well. Thus, a major growth field for foreign insurers is seen in motor insurance. For other

areas like commercial property or cargo insurance it is estimated that foreign insurers' business will grow only moderately. Since these policies are bought by enterprises, many of them will still be under state control for the foreseeable future and these clients might conceivably prefer Chinese insurance companies.

There is, however, another major non-life insurance business line, which so far has been largely neglected in China: insurance for natural catastrophes. It is assumed in the optimistic scenario that demand for insurance against natural catastrophes will strongly grow for two major reasons. The first major reason is that China is geographically and geologically prone to natural catastrophes, with about 12% of all worldwide economic losses and about 15% of all worldwide deaths due to natural catastrophes between 1994 and 2003 happening in China. Of the insurance compensations paid globally for natural catastrophes, however, only about 0.5% were paid in China during the same period, clearly showing that natural catastrophes are heavily underinsured in China. The second major reason is that the awareness of the political class in China for environmental issues or natural catastrophes is rising, or rather the understanding that a damaged environment, be it through exploitation or catastrophes or a combination of both, is hampering long-term economic growth. Although again the state, or large state-controlled enterprises would be the main clients for insurance policies against natural catastrophes, one could assume that in this case international companies will be asked to provide the service, just because it requires very strong and globally experienced insurance companies to cover the area of insuring against natural catastrophes.

Under these assumptions it is estimated that European insurance companies could gain a market share of up to 10% in non-life business by 2010, up from the current market share of about 0.4%. In absolute terms this would mean an increase in non-life insurance premiums for European operators in China from about 44 million EUR (2004) to about 2.5 billion EUR (in 2010), thus a 56-fold increase in premiums. At present, however, only two major European insurance companies, Allianz from Germany and Royal Sun & Alliance from the UK, have positioned themselves as fully foreign-owned non-life insurance providers in China, while 7 major

European insurance companies have founded joint ventures with Chinese companies in the life insurance sector.

The life insurance sector in China at present is, with an annual growth rate of nearly 40%, the fastest growing in the world. In the optimistic scenario it is assumed that this growth will more or less continue with an annual rate above 30%. This assumption is made due to the potentially large and multiple role life insurance can and should play in China. On the one hand it seems to be one of the most appropriate instruments to cover the gaps in social security, which have opened up due to the fact that the SOEs, formerly major providers of social security, drastically reduce this role. On the other hand, life insurance is an appropriate means to collect large amounts of funds on a long-term basis and reinvest them, e.g. into infrastructure needs in China.

Despite the high political importance attached to life insurance for the reasons mentioned above, the optimistic scenario assumes that the Chinese authorities will give full access to foreign life insurers, also as wholly foreign owned companies (which so far is not granted). As has been depicted for the banking sector above, if foreign life insurance companies can go it alone in China, this also increases their negotiating power when it comes to jointly operating with Chinese companies, be it by investing in them or by forming a new joint venture. One major impediment to growth for European insurers in the Chinese life market would still be the need to build up the respective sales channels through agents. But, in comparison to the banking sector, where fully fledged branches are required, it seems manageable to build up a network of agents, in particular if European companies invest in training. Furthermore, direct insurance through virtual channels (internet, TV, telephone) seems to be an upcoming alternative in a technology-savvy China.

All in all, the optimistic scenario foresees that the premiums earned by European life insurance companies could rise from the roughly 300 million EUR at present to up to 18 billion EUR by 2010, with their market share growing from at present about 0.8% to then 12% (see **Table 10**). Among the three sub-sectors in this scenario, banking, non-life insurance and life-insurance, the latter thus shows the strongest growth potential for European operators.

Table 10: Optimistic Scenario Summarised Results

| € (bn) | CN Banking Sector | | | CN Life Insurance | | | CN Non-Life Insurance | | |
|--------|-------------------|-----------|-----------------|-------------------|-------------|-----------------|-----------------------|-------------|-----------------|
| | CN Assets | EU Assets | Market Share EU | Total Premiums | EU Premiums | Market Share EU | Total Premiums | EU Premiums | Market Share EU |
| 2004 | 2,800 | 22 | 0.8% | 33 | 0.3 | 0.8% | 11 | 0.044 | 0.4% |
| 2010 | 5,527 | 330 | 6% | 150 | 18 | 12% | 25 | 12.5 | 10% |

7. SYNOPSIS: MARKET POTENTIAL, MARKET OPENING AND REMAINING MARKET ACCESS BARRIERS

7.1 Market Potential

7.1.1 European Actors in Chinese Banking Market

European actors will in principle be able to participate in capitalising on the expected future growth in various segments of the Chinese banking sector. In the Chinese private individuals and family business, annual growth projections for various business fields on the asset side are estimated at around 20% for general consumer and special loans (car loans, mortgage loans). Tremendous growth rates of around 50% annually are expected in some sectors such as the credit card business. On the liabilities' side, however, no significant growth is expected for deposits, which are already at record-high levels. In this market segment a shift away from simple deposits towards other, more sophisticated, savings or insurance products can be expected. Much of the additional market share on this side will thus go to insurance companies, who offer alternative products for depositors. However European banks will also be able to capitalise on this development by offering advanced savings products.

Due to the growing financing requirements in private enterprises in China in particular, significant growth, albeit not as dramatic as in the field of consumer financial services, is also expected in the corporate client and SME business. One requirement for increased lending to private enterprises and SMEs however, is that the effective credit supply to SOEs is reduced. The Chinese government is following a strategy to achieve the necessary two-tiered "gradual" reform of the SOE sector, accompanied by reforming the major state banks which lending to SOEs. A key element in this strategy is the involvement of foreign capital to share risks and expertise to upgrade capabilities. Within a growing and shifting corporate banking market, advanced products such as structured finance or capital market oriented products (such as securitization and/or trading NPL portfolios) could allow European and other foreign banks to take advantage of their superior knowledge and expertise in these areas. Last but not least, trade finance in all its forms will inevitably grow further with the increasing importance of China as exporter and importer on international markets.

In principle, European banks are well positioned to tap into new and growing market segments; between 35 and 40% of foreign banking assets in China are held by

European banks. US banks hold a similar share of foreign bank assets in China, tending to have less but larger, more concentrated, investments. Japanese banks, with close to around 20% of foreign banking assets in China, are another considerable group of players, but so far have abstained from investing into existing Chinese banks. Banks from ASEAN countries so far do not play any significant role. Indeed only Singapore, through its state investment wing Temasek, holds a significant share of foreign bank assets in China. The degree to which European (and other foreign) banks than can make further inroads into the market depends strongly on how market access conditions evolve and WTO agreements are implemented.

7.1.2 European Actors in Chinese Insurance Market

In the Chinese insurance sector, European actors are also well-represented among foreign insurance companies. Besides European actors and US insurers, Japanese companies play a leading role, whereas companies from ASEAN countries are only marginally represented. Unlike in the banking market, the insurance market is expected to grow across all market segments. Again, the strategy and potential of European insurers to benefit from these growth opportunities strongly depends on de facto market openness.

7.2 The Post-December 2006 Legislative Environment

In the banking market, the last major step to be taken in December 2006 is to allow foreign banks to engage in RMB business with private clients. All other client-based or geographical WTO-relevant impediments have already been removed. This new freedom to do RMB business with all types of clients was formally seen to be a tremendous step, but practical reality has shown that other limits and existing barriers will prevent quick market penetration by European and other foreign banking institutions.

In the insurance sector, all major formal restrictions, the removal of which China had committed to under the WTO agreement, have been removed in previous years. The only outstanding formal commitment still to be fulfilled by the end of 2006 is in the area of insurance brokerage⁵⁸. They will then be allowed to raise their equity participation in existing joint ventures to more than 51%, and even to open up fully foreign owned subsidiaries.

With China's 11 December 2006 promulgation of new regulations to govern foreign banks' activities, banking regulations

seem, at least on paper, to have conformed with its WTO commitments – something that Chinese officials are keen to highlight, claiming that: “[by 2007, there will be] no limitations on the share of foreign banks in financial institutions”. In practice, however, the discriminatory regulatory treatment of foreign banks will remain, and China notably continues to apply ownership caps on foreign shareholdings in Chinese banks - despite the fact that China's GATS schedule lists no foreign equity caps.

7.3 Remaining Market Access Barriers

These remaining regulatory restrictions, which the Chinese side considers to be in compliance with WTO rules, are such that only a profound legal analysis could show whether or not they are indeed in compliance with China's WTO commitments. These are outlined below:

Insurance sector⁵⁹:

- The legal impossibility to operate life and non-life insurance from one legal entity: Since this is part of China's insurance law and also applies to Chinese insurance companies, one should believe that it would be WTO-compliant. In any case, insurance groups in principle could set up as holding companies, offering both types of products, life and non-life, an approach that Chinese insurers are often taking.
- The limit of foreign participation in Chinese life-insurance companies to a 50% stake: This restriction certainly is very relevant, since it prevents foreign companies fully engaging in the very fast growing market of Chinese life- and health-related insurance products. The WTO compliance of this regulation could also be tested, since one US investor indeed holds a 100% stake in a life-insurance company, and one European and Canadian insurance company hold a 51% stake in their respective joint ventures.
- Difficulties in obtaining operating licences: Sino-Foreign life insurers have severe difficulties in obtaining licenses to operate in new provinces. This means insurers are effectively prevented from creating national distribution networks at the same speed as domestic insurers.

In the banking sector, remaining restrictions are more a question of how regulations are implemented rather than how formal regulations are set out. Main impediments are seen in:

- Difficulties to set up a branch network, due to excessive capital and liquidity requirements⁶⁰ on the one hand, and a very slow process of licensing branches of foreign banks on the other hand.
- Excessive liquidity requirements render lending business, both in RMB and foreign currency, more difficult to foreign than to Chinese banks.
- The implementation of the recently adopted foreign-funded banking law is limited in that, although it removes the geographic restrictions on foreign banks' institutional RMB business, the requirement to incorporate local subsidiaries to be able to offer local retail RMB business and bank card business was not envisaged in China's WTO commitments. Arguably, these conditions will require most international banks to radically restructure their operational structures in China⁶¹.

Additionally there are some impediments to market access for foreign banks, which are not directly affected by financial sector regulation, but rather through regulation of other parts of the economy:

- Since SOEs must apply with the authorities if they want to open accounts or assume loans, the authorities can of course indirectly decide which bank (Chinese or foreign) will in actual fact win business.
- Similarly, for the financing of foreign trade operations the general regulations on foreign currency can be used by the authorities to continually exclude foreign banks from large parts of the market.

8. RECOMMENDATIONS FOR EU TRADE AND INVESTMENT POLICY VIS-À-VIS CHINA

The fact that one US-based insurance company obviously has a 100% stake in a Chinese life insurer, something no European insurer has, could be tested under the Most Favoured Nation (MFN) treatment principles. Another issue of possible non-adherence to WTO commitments is seen in the excessive and officially “prudential” regulations imposed on foreign banks in comparison to their Chinese counterparts. If these are indeed “non-prudential” regulations or impediments, they might contradict China's WTO commitment to skip all such foreigner-specific “non-prudential” regulations. A legal analysis on this issue however is beyond the scope of this study.

In any case, if the EU intends to confront China on market opening issues in the financial sector, be it under the WTO umbrella or in other forms, the EU should take an “integrated approach”. Since China has no major stakes in the European financial sector yet, and is not expected to do so in the near future, the EU would have to discuss to tie opening up of the financial sector with the opening of other sectors with China in order to achieve concessions in further financial market opening. Pure “retaliatory (tit-for-tat) measures” against Chinese financial companies planning to operate in the EU would therefore be ineffective; since China has no significant stakes abroad in the financial sectors the EU has little leverage here.

The EU should summarise and then jointly represent the interests of banks and insurance companies of all EU member states in any discussions on further market opening measures with the Chinese side. US financial companies, who are the main competitors to European companies within the group of foreign financial companies, certainly benefit from the advantages of a joint and forceful governmental representation mechanism when it comes to market access and market opening issues in China. If possible, even joint positions of EU and US trade policy vis-à-vis China should therefore be sought and implemented in negotiations with China.

The main issues and sub-sectors onto which EU trade policy and negotiations should concentrate in the field of further market opening in China’s financial markets are derived from the study as follows:

Banking sector:

- Easing of branch network licensing regulations and implementation rules;
- Easing of regulatory treatment of bank branches concerning capital and liquidity (essential if European banks are to capture larger parts of the RMB market);
- Easing of ownership ceilings domestic Chinese banks;
- Full and non-discriminatory access to foreign trade finance, not impeded by foreign currency regulations hindering foreign banks.

Generally, when confronting China with the opening of the banking market it should be kept in mind that China’s reform policy in the

banking sector is led by an “internal conflict of interest”. On the one hand, it is in the interest of the Chinese to modernise the banking sector and in order to achieve this foreign investors are explicitly welcome, in particular if they invest minority stakes in existing Chinese banks. On the other hand, China wants to achieve a gradual winding-down of parts of the inefficient SOE sector. In order to keep this process “gradual” and thus to avoid larger economic and social stability problems, the authorities must continuously try to keep these SOEs financed through the state-dominated banking sector. Full competition in the banking sector, particularly in deposits, which are required to maintain the high liquidity level of state-dominated banks, which channel loans to SOEs, contradicts this approach. Thus, for the foreseeable future it should not be expected that China would allow such a high degree of competition on the RMB deposit market that it would endanger the refinancing and liquidity of its state-dominated banking sector and thus its SOE sector.

Insurance sector:

- Opening up of the life-insurance market so that European providers are entitled to operate as fully foreign owned life insurance companies;
- Make it easier for life insurance companies with foreign participation to obtain licences for operations in new provinces allowing nation-wide competition on an equal footing with Chinese life insurance companies.
- Removal of impediments to supply third party motor vehicle insurance for European companies in the non-life sector, since this is among the most important “bread and butter” businesses in China’s non-life insurances sector.

Other than in the banking sector, further opening up of China’s insurance market should not endanger economic or social stability in China to any degree. It is a rather young market and with much less connections to as of yet unreformed parts of China’s “dual economy”. Chinese protectionism in the insurance sector therefore is just that, and no “legitimate means” to insure economic and social stability can be justified.

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ANNEX 1: QUANTITATIVE COST ASSESSMENT MODEL: BANKING SECTOR

I) Main Administrative Barriers despite WTO Implementation:

- Delayed branch opening: 1 per year, 1 at a time
- Costly branching: capital and liquidity requirements „as if“ new bank license required
- Restricted RMB refinancing on interbank market

II) Main short-term effects of administrative barriers on business development:

- Heavy negative impact on retail (deposits) business (assumption: 70% of their potential business volume withheld from foreign banks until 2010)
- Heavy negative impact on RMB lending business (assumption: 50% of their potential business volume withheld from foreign banks until 2010; impact lower than on deposit business, since some lending can be effected based on interbank market refinancing)
- Medium negative impact on foreign currency lending business outside large commercial cities (assumption: 30% of their potential business volume withheld from foreign banks until 2010)

III) Assumptions for calculating short-term costs of such administrative barriers / expected business development effects:

Retail RMB Deposit Business:

Retail (deposit) business shows high competition and low margins. Assumed profit margin 1% p.a. on deposits held. RMB deposits are expected to grow at only 2% p.a., since more alternative products will be provided. Current RMB deposits in China are estimated at 2,217 billion EUR. Given above assumption, this amount in 2010 would stand at 2,448 billion. Currently European banks in China hold an estimated 0.16% of RMB deposits, or EUR 3.6 billion in RMB deposits. Without administrative barriers it is assumed that the share of EU banks in RMB deposits would grow to 7% by 2010 or EUR 171 billion. The following business volume development would be assumed (without barriers):

- 2006: EUR 5 billion, 2007: EUR 10 billion, 2008: EUR 40 billion, 2009: EUR 100 billion, 2010: EUR 171 billion⁶²
- Given the restrictions and barriers, the following growth path is estimated: 2006: EUR 5 billion, 2007: EUR 7 billion; 2008: EUR 15 billion, 2009: EUR 25 billion, 2010: EUR 51 billion

RMB Lending Business:

RMB lending business shows medium competition and medium margins. Assumed profit margin 2% p.a. on loans outstanding. RMB Lending is assumed to annually grow with 8% (same growth as estimated for banking sector assets). Current outstanding RMB loans in China are estimated with 2,074 billion EUR. Given above assumption, this amount in 2010 would stand at 3,047 billion. Currently European banks in China hold an estimated 0.2% of RMB loans, or EUR 4.5 billion RMB loans. Without administrative barriers it is assumed that the share of EU banks in RMB loans would grow to 6% by 2010 or EUR 183 billion. The following business volume development would be assumed (without barriers):

- 2006: EUR 10 billion, 2007: EUR 20 billion, 2008: EUR 40 billion, 2009: EUR 100 billion, 2010: EUR 183 billion⁶³
- Given the restrictions and barriers, the following growth path is estimated: 2006: EUR 8 billion, 2007: EUR 15 billion; 2008: EUR 30 billion, 2009: EUR 60 billion, 2010: EUR 91 billion

Foreign Currency Lending Business:

- Foreign Currency lending business shows limited competition and higher margins.
- Assumed average profit margin until 2010 of 2.5% p.a. on outstanding loans.⁶⁴
- Foreign Currency Lending is assumed to grow annually by 2% (due to the increasing convertibility and international role of the Chinese currency, a “de-dollarisation” of the Chinese economy is expected and thus only below-average growth of foreign currency lending).

Current outstanding foreign currency loans in China are estimated with 109 billion EUR. Given the assumptions above, this amount in 2010 would stand at 120 billion. Currently European banks in China hold an estimated 8.4% of foreign currency loans, or EUR 9.2 billion foreign currency loans. Without administrative barriers it is assumed that the share of EU banks in foreign currency loans would grow to 20% by 2010 or EUR 24 billion. The following business volume development would be assumed (without barriers):

- 2006: EUR 12 billion, 2007: EUR 15 billion, 2008: EUR 19 billion, 2009: EUR 22 billion, 2010: EUR 24 billion
- Given the restrictions and barriers, the following growth path is estimated: 2006: EUR 11 billion, 2007: EUR 13 billion, 2008: EUR 15 billion, 2009: EUR 16 billion, 2010: EUR 17 billion

IV) Results: Short-term (2006-2010) costs of administrative barriers for EU banks

- Costs of restricted RMB deposit business: 2006: EUR 20 million, 2007: EUR 100 million, 2008: EUR 200 million, 2009: EUR 800 million, 2010: EUR 1.8 billion
- Costs of restricted RMB Lending Business: 2006: no effect, 2007: EUR 30 million, 2008: EUR 250 million, 2009: EUR 750 million, 2010: EUR 1.2 billion
- Costs of restricted foreign currency lending business: 2006: EUR 25 million, 2007: EUR 50 million, 2008: EUR 100 million, 2009: EUR 150 million, 2010: EUR 175 million

V) Results: Long-term negative effects:

Without proper access to both RMB deposit and lending business, European banks will not be able to retain their competitive positions in China in the long run, but will be marginalized by Chinese banks (and their strategic partners/investors) with improved performance. Without proper access to RMB deposit and lending business, the business model of setting up wholly foreign owned banks with fully-fledged operations in China will become obsolete. Remaining successful business models would then only be specialised banks (e.g. investment banking) or the participation of European banks (usually as minority shareholders) in Chinese banks. Given that foreign banks already have a strong foothold in foreign currency lending in major commercial cities, no additional long-term negative of existing barriers apart from the short-term costs estimated above are expected. The remaining indirect constraints on expanding foreign currency lending of European banks should therefore not render strategic negative effects, in particular since the role of foreign currency lending in China in general is expected to diminish in comparison to RMB lending.

ANNEX 2: QUANTITATIVE COST ASSESSMENT MODEL: INSURANCE SECTOR

I) Main Administrative Barriers despite WTO Implementation:

- Non-life sector restrictions: motor third party liability insurance
- Life-sector restrictions: no stand-alone foreign insurance companies

II) Main short-term effects of administrative barriers on business development:

- Heavy negative impact on foreign stand-alone non-life insurance companies due to restrictions in motor vehicle insurance (assumption: 25% of their potential business volume withheld from foreign insurers until 2010)
- Heavy negative impact on foreign life-insurance providers due to impossibility of going stand-alone (40% of their potential business volume withheld from foreign insurers until 2010)

III) Assumptions for calculating short-term costs of such administrative barriers / expected business development effects:

Non-Life Insurance Business:

Non-Life Insurance Premiums in China are expected to grow at an average annual rate of 12%. This estimation is based on an expected annual GDP growth of 8% and a still "under-insured" market. The assumed profit margin of sold insurance premiums is 5%. 2004 premiums for non-life insurance in China were at around EUR 11 billion EUR. Given the above assumption, this amount in 2010 would stand at EUR 22 billion. Currently European insurers in China hold an estimated 0.37% of the non-life insurance market, thus estimated premiums EUR 41 million. Without administrative barriers it is assumed that the share of EU insurers in non-life premiums would grow to 7% by 2010 or EUR 1.6 billion premiums. The following business volume development would be assumed (without barriers):

- 2006: EUR 80 million, 2007: EUR 200 billion, 2008: EUR 500 billion, 2009: EUR 1 billion, 2010: EUR 1.6 billion⁶⁵
- Given the restrictions and barriers, the following growth path is estimated: 2006: EUR 52 million, 2007: EUR 130 million; 2008: EUR 325 million, 2009: EUR 650 million, 2010: EUR 1.2 billion

Life Insurance Business:

Life Insurance Premiums in China are expected to grow at an average annual rate of 15%. This seemingly very optimistic estimation is based on an expected annual GDP growth of 8% and the fact that life-

insurance products⁶⁶ will face a hugely growing role in replacing social security systems previously provided by State-owned enterprises. The assumed profit margin of sold insurance premiums is at 5%. 2005 premiums for life insurance in China were at around EUR 38 billion EUR. Given above assumption, this amount in 2010 would stand at EUR 76 billion. Currently European insurers in China hold an estimated 0.8% of the life insurance market, thus estimated premiums of EUR 3 billion. Without administrative barriers it is assumed that the share of EU insurers in life insurance premiums would grow to 15% by 2010 or EUR 11 billion. This significant rise of potential EU companies' share in total premiums (if compared to non-life) is based on the fact that companies with strong experience and high innovative potentials can grow quicker than their less innovative Chinese counterparts in a still underdeveloped and fast growing market.

The following business volume development would be assumed (without barriers):

- 2006: EUR 3.5 billion, 2007: EUR 4 billion, 2008: EUR 6 billion, 2009: EUR 8 billion, 2010: EUR 11 billion⁶⁷
- Given the restrictions and barriers, the following growth path is estimated: 2006: EUR 3.5 billion, 2007: EUR 4 billion; 2008: EUR 4.5 billion, 2009: EUR 5.5 billion, 2010: EUR 6.6 billion

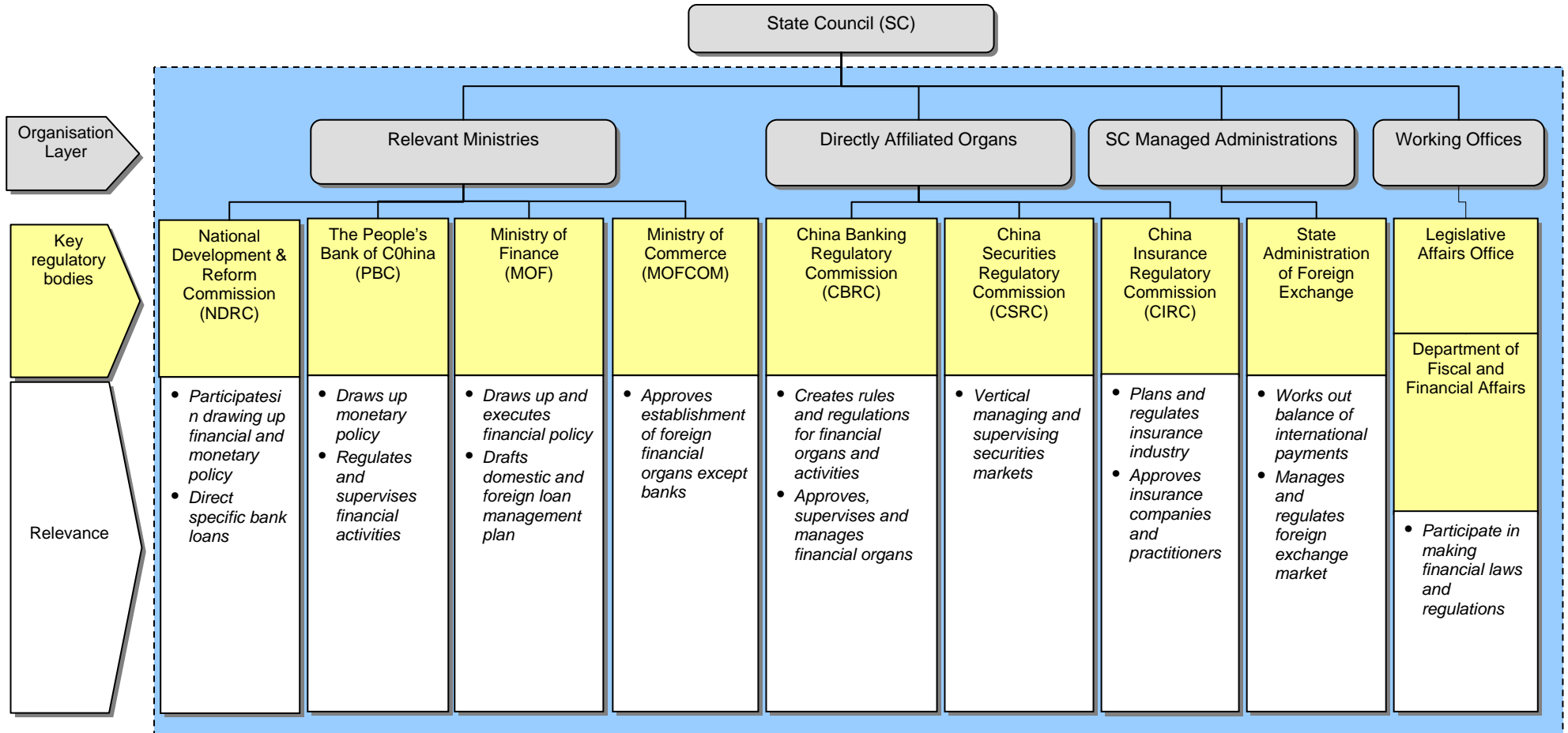
IV) Results: Short-term (2006-2010) costs administrative barriers EU insurers

- Costs of non-access to motor insurance in non-life insurance business: 2006: EUR 1.4 million, 2007: EUR 3.5 million, 2008: EUR 8.8 million, 2009: EUR 17.5 million, 2010: EUR 20 million
- Costs due to not allowing stand-alone life insurers: 2006: no effect, 2007: no effect, 2008: EUR 75 million, 2009: EUR 125 million, 2010: EUR 220 million

V) Results: Long-term negative effects:

Significant negative long-term effects will be mainly felt, if European insurers are not allowed to form stand-alone companies in the hugely growing life-insurance business. Given its probability of a dramatically increasing role as a substitute for social security provided previously by SOEs and the state, this market has very high potential. When forced to work as minority shareholders with Chinese partners, neither products nor procedures of European insurers can be protected, nor will European insurers then be able and willing to apply their full home-based experience.

ANNEX 3: RELEVANT GOVERNMENT INSTITUTIONS FOR CHINA'S FINANCIAL SERVICES SECTOR



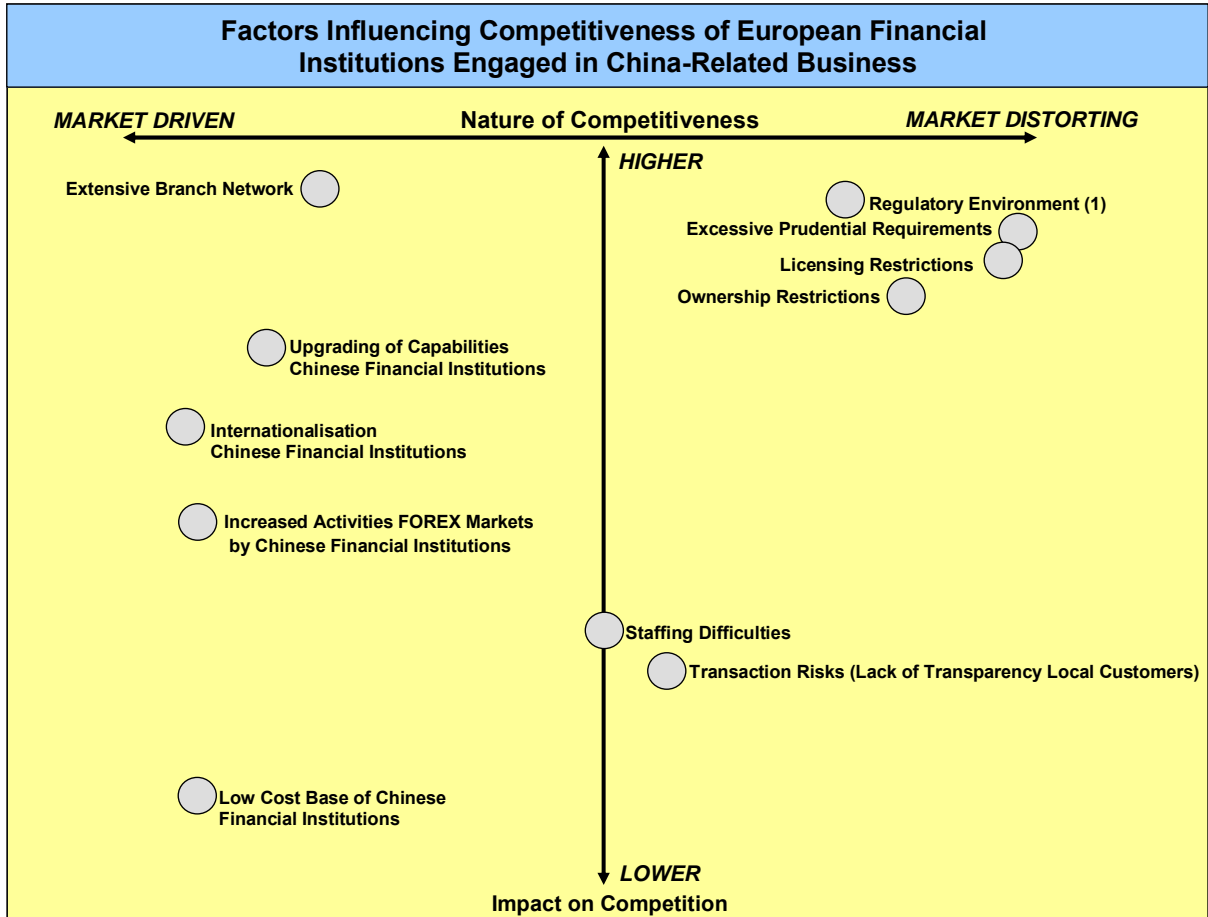
ANNEX 4: TABLE OF KEY LAWS AND REGULATIONS PERTAINING TO FINANCIAL SERVICES SECTOR

| Sub-sector | Key Laws and Regulations |
|--|--|
| <p>I) Banking</p> <p>Banking services as listed below:</p> <ul style="list-style-type: none"> a. Acceptance of deposits and other repayable funds from the public; b. Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction; c. Financial leasing; d. All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts(including import and export settlement); e. Guarantees and commitments; f. Trading for own account or for account of customers: foreign exchange. | <p>The Law of the People's Republic of China on Commercial Banks has been amended accordingly on December 27, 2003 ,effective as of February 1,2004.</p> <p>The Law on Regulation of and Supervision over the Banking Industry, adopted on December 27, 2003, effective as of February 1, 2004</p> <p>Newly promulgated regulations concerned include but not limited to:</p> <p>Regulations on the Administration of Foreign-Funded Banks adopted 11 December 2006, issued by the State Council.</p> <p>Regulation of the People's Republic of China on the Administration of Foreign-Invested Financial Institutions promulgated on December 20,2001, effective as of February 1,2002;</p> <p>Detailed Rules for the Implementation of the Regulation of the People's Republic of China on the Administration of Foreign-Invested Financial Institutions promulgated on July 26,2004, effective as of September 1,2004;</p> <p>Measures for the Administration on Consolidated Financial Statements in Conducting Supervision Over Foreign-Invested Banks promulgated on March 8,2004 , effective as of April 1, 2004;</p> <p>Interim Measures for the Administration of the Basic Data of Individual Credit Information promulgated by PBOC on August 18,2005, effective as of October 1,2005.</p> |
| <p>II) Insurance</p> <p>All Insurance and Insurance-Related Services</p> <ul style="list-style-type: none"> a. Life, health and pension/annuities insurance b. Non-life insurance c. Reinsurance d. Services auxiliary to insurance | <p>The Insurance Law has been amended accordingly on October 28,2002, effective as of January 1,2003.</p> <p>Newly promulgated regulations concerned include but not limited to:</p> <p>Regulation of the People's Republic of China on the Administration of Foreign-Invested Insurance Companies promulgated on December 12, 2001, effective as of February 1, 2002;</p> <p>Detailed Rules for the Implementation of the Administrative Regulation of the People's Republic of China on Foreign-Invested Insurance Companies promulgated on May 13, 2004, effective as of June 15, 2004;</p> <p>Regulation of Administration on Insurance Brokerage Institutions promulgated on December 15, 2004, effective as of January 1, 2005;</p> <p>The Provisions Governing Reinsurance Business, promulgated by CIRC on October 14,2005, effective as of December 1,2005.</p> <p>Pursuant to Catalogue of Industries for Guiding Foreign Investment (Revised 2004) promulgated on November 30, 2004, effective as of January 1, 2005, wholly foreign owned non-life insurance companies and the wholly foreign owned insurance brokerage companies should be permitted to be established in China not later than December 11, 2003 and December 11, 2006 respectively and the foreign investment proportion in a foreign investment life insurance company shall not exceed 50% .</p> |

ANNEX 5: FACTORS INFLUENCING COMPETITIVENESS IN THE CHINESE MARKET

In addition to the genuine market driven competitive threats posed by Chinese operators in this sector, European companies also face competitive forces as a result of non-tariff or 'behind the border' barriers. Those NTBs which are deemed to result from strong Chinese government intervention are plotted on the right of the horizontal axis while those derived from genuine competition are plotted on the left of the horizontal axis.

The author has indicated the relative importance of these competitive forces in terms of their position on the vertical axis with those nearer the top deemed as the most significant. The graph is designed as a guide only to give some perspective to the descriptions of competitive forces in this sector.



Note: (1) Difficulties in the regulatory environment includes drafting and implementation of regulations; transparency of regulation and implementation rules; inconsistent application of legislation; and constant changes in the Chinese legal environment.

Financial Services

SECTION 1: Financial Services Overview

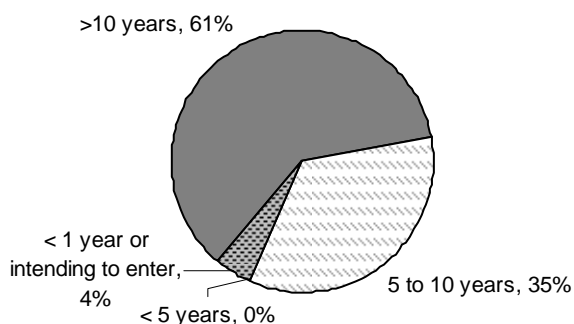
1.1 Legal Entity

Table 1 – Sample Group Profile

| Financial Institutions | |
|------------------------|-----------|
| Branches | 13 |
| JV | 5 |
| Rep Office | 3 |
| Other | 2 |
| Total | 23 |

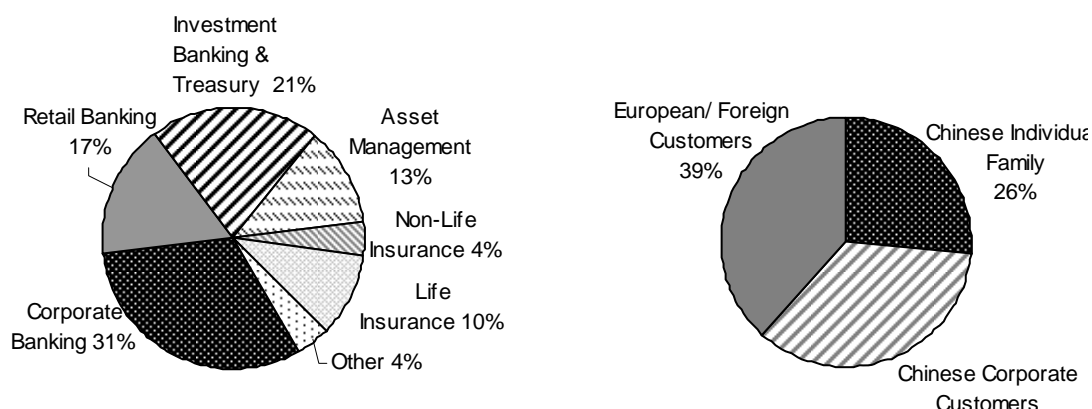
1.2 How many years has your organisation engaged in China-related business?

Chart 1- Years Engaged in China-related Business



1.3 Which market segments does your China business operate or intend to operate in?

Chart 2 & 3- European Financial Sector Market Segments in China

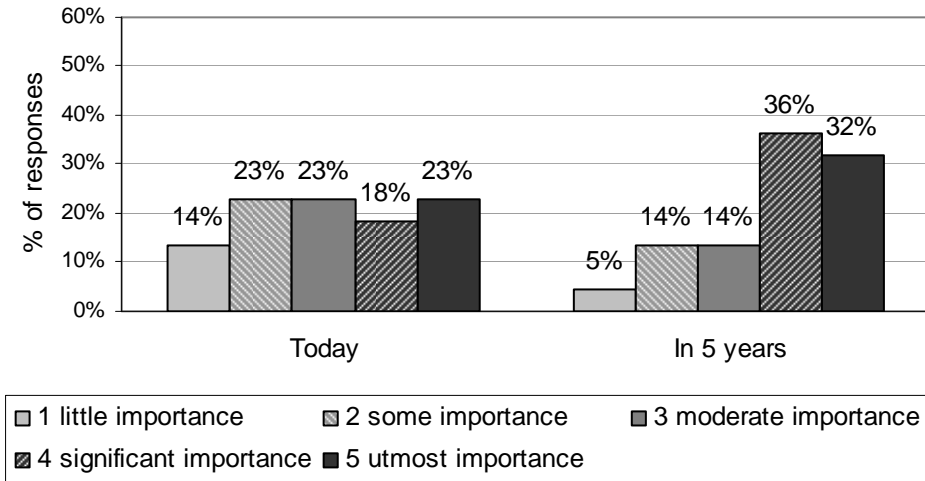


Among the European financial Institutions surveyed, the main focus of operating in the financial market remains corporate banking (31%) with a focus on European and other foreign customers (39%). Increasingly, asset management and the retail sector are becoming important for European banks but often in cooperation rather than in direct competition with Chinese financial institutions.

SECTION 2: CHINA MARKET OPPORTUNITIES

2.1 How important is China as a new market to increase your customer base?

Chart 4- Importance of Chinese Market to Increase Customer Base



The majority of respondents (41%) rate the Chinese market as of significant or of utmost importance to increasing their global customer base. This trend is set to continue with some of the lifting of restrictions in 2006. In five years time, 68% of industry representatives interviewed expect the Chinese market to be of significant or of utmost importance. The average importance given to the Chinese market is 3.1 now and expected to be 3.7 in five years.

2.2 What is the percentage of your company's turnover in China compared to your global business? & 2.3 Over the next 5 years, how do you expect business opportunities to evolve in your sector of operation in China? How will this likely impact on your sales/market figures?

The Chinese market is more important in strategic terms than is reflected by its absolute value to European financial institutions. Banking services within the Chinese market constitute only a small proportion of European banks' global balance sheet (less than 1% on average). In the insurance sector European companies are already more active, although their global share of gross premiums in the Chinese market still typically ranges between 1 and 3.5%

75 % of those responding to this question expect a significant increase in their balance sheets in China. These respondents expect on average a growth rate per annum of 20% with some quoting as high as a 40% growth rate per annum. However, in terms of market share, European banks at most expect to gain 1-2% of the Chinese market by 2010. The life-insurance sector is expected to boom, with figures quoted as high as between 60-70% per annum in terms of growth in gross premiums. Market share for all European insurance companies combined is not expected to exceed 5%.

2.3 How important is China as a direct investment destination (e.g. by establishing branches; investing in local banks)

The strategic importance of China is better explained by the amount of financial capital that European financial institutions will be investing in the hope of establishing a long-term foothold in the Chinese market. Today, 41% of respondents consider China as of significant or utmost important as an investment destination, in five years time, 62% expect this to be the case. This investment includes the setting up of new branches, acquisition of an ownership stake in a Chinese financial institution or more limited participation in the Chinese market such as strategic partnerships or representative offices. On average this trend represents a shift from 3.1 to 3.6 importance.

Chart 5- Importance of Chinese Market as a Direct Investment Destination⁶⁸

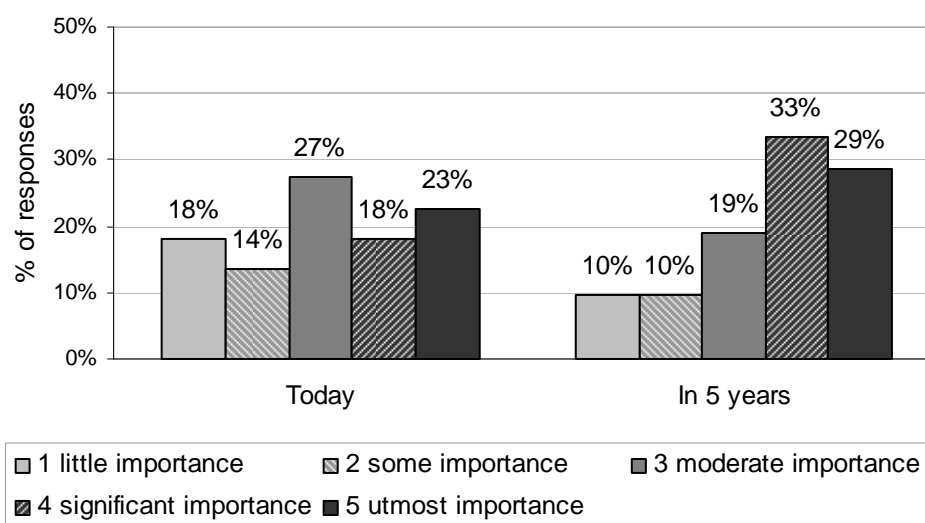
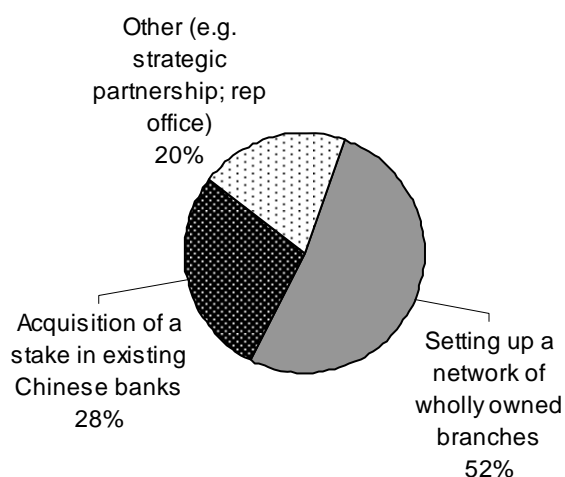


Chart 6- Preferred Mode of Expansion in the Chinese Market

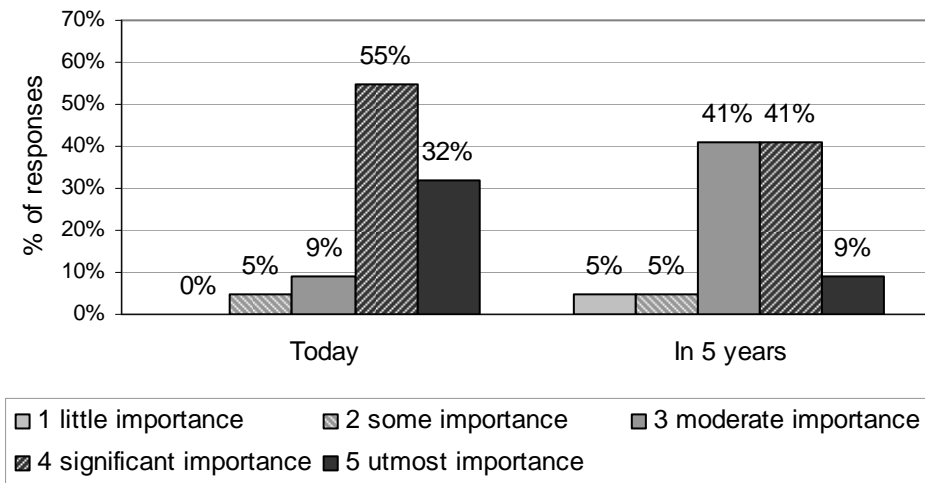


As can be seen from **Chart 6** the majority of respondents prefer to set up their own network of wholly owned branches (52%). For larger financial institutions a 'two-tiered approach', serving mainly corporate customers through their branch network while accessing Chinese retail customers through their stake in a Chinese financial institution is a common strategy. For some, owning a stake in a Chinese financial institution is primarily intended to distribute financial products such as insurance.

How much of a problem would you rate Chinese market access and other commercial practices?

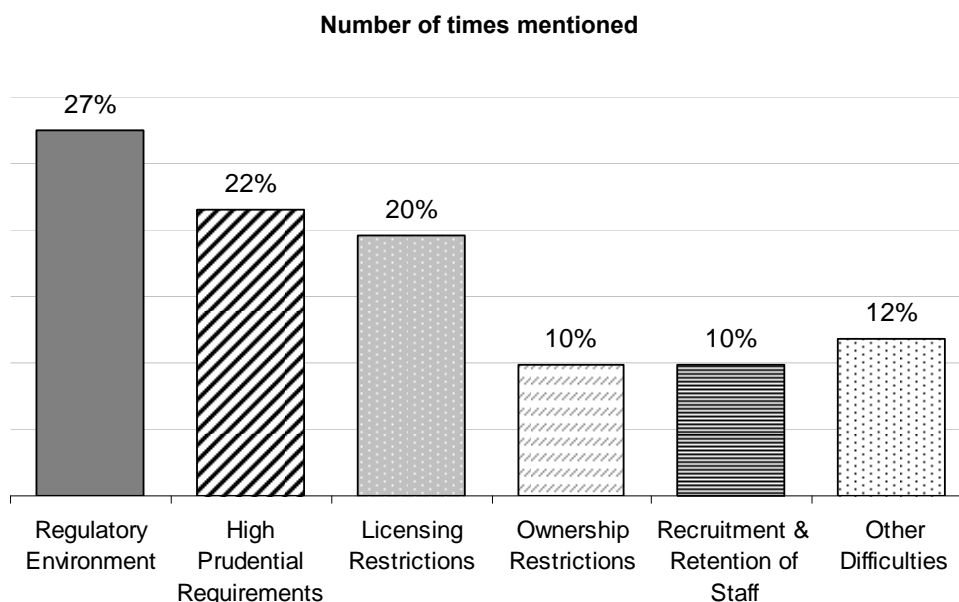
With 87% of respondents citing market access and other commercial obstacles as at least of significant importance, the sentiment among financial sector representatives in China seems to be that they operate within a severely restricted market. This situation is expected by respondents to moderately improve, with half (50%) expecting market restrictions to be of significant importance in five years time. In terms of averages, this is a reduction from 4.1 to 3.4 in importance

Chart 7- Importance Chinese Market Access Obstacles & other Commercial Practices⁶⁹



2.5 What are the main current obstacles preventing you from expanding further in the Chinese market? Please list in terms of priority.

Chart 8- Recurrence of Market Obstacles Cited in Survey



In 27% of responses, industry representatives cited the larger **regulatory environment**⁷⁰ as one of the main obstacles preventing further expansion in the Chinese market. This problem was also most frequently cited as the most important challenge faced by European financial institutions (40% of surveys). Many industry practitioners say that although they understand the difficulties the Chinese government faces in reforming the financial sector, the way regulations are drafted and implemented are a major concern. To take the SAFE⁷¹ regulations as an example, many industry representatives do not consider the policy itself a primary concern but rather how it is implemented in practice and the many grey areas it contains. Different regulatory bodies have insufficient dialogue to ensure consistency and there are local regulatory variations with regulations being interpreted differently among different regions. Furthermore, many regulations are not uniformly implemented for foreign and local financial institutions while some legislation, such as the foreign debt quota for banks, only hurts foreign banks.

In second place are the **high prudential requirements**⁷² (22%) for setting up new branches and licensing restrictions. Even after 2006 many industry representatives are concerned that the geographical scope of their activities is severely restricted due to prudential requirements. A representative at a smaller bank's representative office commented that a loosening of prudential requirements would mean the difference between no business and at least some business, pointing out that it would cost a Chinese bank only €5 million to set up a branch in the EU when it costs €40 million (depending on what licenses are needed) to set up a similar branch for an EU bank in China. In terms of **licensing restrictions**⁷³ (20%), the micro-management by the Chinese government in a wide range of areas, are considered overly bureaucratic and time consuming and is which industry practitioners believe should be business decision, not an administrative one. As one practitioner at a medium-sized bank argues, not being able to freely offer sophisticated and tailored financial derivatives not only limits his own business scope, but at the same time limits the competitiveness of China-based companies on the international market by not having the same set of strategic financial tools at their disposal as competitors in other places.

Following in fourth place, and an issue for the larger financial institutions in particular, is the **current restrictions on ownership**⁷⁴. The difficulty of **recruiting & retaining capable staff** is

also highlighted (10%) while a range of **other difficulties**⁷⁵ (12%), notably the lack in transparency at local enterprises and cultural issues, are also mentioned.

Table 2 – Recurrence of Market Obstacles Cited in Survey

| Selected Comments | |
|---|---|
| Regulatory Environment | “The unclear legal environment is a consequence of a purposeful ‘strategic ambiguity’ on the part of the Chinese government leaving the power with the authority on how rules and regulations should be implemented. At the same time rules that have been codified are not enforced equally. We get regulators from almost every possible government body coming to our office almost every day to check our books for compliance with regulations. This wastes a lot of management time and local Chinese banks are not put under the same scrutiny. As it is clear that we easily meet or exceed government regulations, we suspect that this is also a ploy to see first-hand how a proper banking branch is run and to observe best practice. In this area it might be more appropriate to ‘wield the big stick’, I am not sure what can be done in the WTO context but this clearly constitutes unequal treatment and should be faced by severe sanctions.” |
| Barriers to Market Entry | “To some extent we can already see that with the ending of this round of WTO implementation, many non-tariff barriers are already being set up. For example borrowing money from abroad is restricted by a quota system which is related to the previous year’s business. For foreign banks it is therefore difficult to re-finance by using money from an off-shore location which is a disadvantage due to their difficulty in attracting RMB deposits and the lack of a developed inter-bank market.” |
| Licensing Restrictions - Banking | “Not being able to freely offer sophisticated and tailored financial derivatives not only limits our own business scope, but at the same time limits the competitiveness of China-based companies on the international market by not having the same set of strategic financial tools at their disposal as competitors in other places.” |
| Licensing Restrictions - Insurance | “Geographical scope of business is still limited as license is required for each separate territory and these are hard to come by. Furthermore each region has its own prudential requirements (e.g. interest rate floors etc.) which limit how easily the market can be exploited. These factors make corporate strategy/tactics largely set by the legislative environment, creating limited scope for competitive differential.” |

2.6 What are the quantitative costs or impacts resulting from these obstacles on your business today? This can be indicated as a percentage of revenues, profits, etc. Please specify.

Table 3 – Quantitative Costs or Impacts of Market Access Obstacles

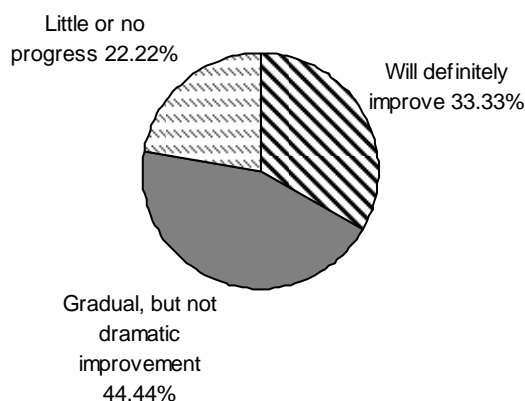
| Where respondents found it difficult to quantify market access obstacles: | | |
|--|-------------|-----------|
| Comment | Sub- sector | |
| | Banking | Insurance |
| “The cost is to our activities [resulting from market obstacles] is substantial, but I have no estimation.” | • | |
| “Let me put it this way: Now there is no business for us in China. If these restrictions did not exist we would have at least <i>some</i> business.” | • | |
| “The quantitative cost to our operations is difficult to estimate. We suffer from a high cost of capital, (i.e. current ROE for the group x operative capital required). Revenue lost for not having an RMB license is probably huge due to lost opportunities. The costs resulting from a constantly evolving legal environment, strict reporting and licensing requirements for new products is all .” | • | |
| “I can’t really say but we are making a profit – that’s what matters. In this sense the market seems large enough to sustain different organizations with variable levels of profitability.” | | • |
| “Market obstacles mean the difference between a non-profitable and a profitable business for us” | | • |

| | | | |
|--|---|-------------------|------------------|
| "Difficult to quantify, but I estimate that market penetration by foreign insurers is well below potential." | | | • |
| Where respondents made estimates: | | | |
| Comment | | Sub-sector | |
| | | Banking | Insurance |
| "Could be as much as 100%" - Life Insurance JV | | | • |
| "Several dozen million EUROS" – Corporate; Retail, Asset Management; Investment Banking | | • | |
| "If we were able to compete like a Chinese bank we might even get 100% more business" – Corporate Banking; Asset Management; Investment Banking | | • | |
| "With full access to the Chinese market we could be up to a 100 times larger than we are today." – Corporate Banking; Retail Banking, Asset Management; Investment Banking | | • | |
| "We would be about double our current size if we did not have restrictions" – Corporate Banking; Investment Banking; Asset Management | | • | |
| "Overall, 50% of our potential revenue is lost due to the unfavourable legal environment" – Corporate Banking; Retail Banking; Investment Banking & Treasury | | • | |
| "We would double our business without current obstacles" – Corporate Banking; Treasury | | • | |
| Where respondents made specific calculations: | | | |
| Comment | | Sub-sector | |
| | | Banking | Insurance |
| RMB business restrictions | "30-50 % of turnover" | • | |
| Management time | "We lose around 20% of our management time dealing with the bureaucracy and regulatory process. We get regulators from almost every possible government body coming to our office almost every day to check our books & compliance to regulations. This wastes a lot of management time and local Chinese banks are not put under the same scrutiny." | • | |
| High prudential requirements | "Due to extensive [capital adequacy] ratio requirements for foreign-funded banks and high capital requirements we anticipate a slowdown of 10-20% in sales" | • | |

2.7 How do you believe these market obstacles will evolve over the next five years?

The majority of respondents (44.4%) expect gradual, but not dramatic, improvement in the aforementioned market obstacles. 33.3% of respondents are more optimistic, expect a more wholesale change to take place. A minority of respondents (22.2%) expect to see little or no progress.

Chart 9- Evolution on Market Access Obstacles



2.8 China's 11th 5-year programme (2006 to 2011) sets ambitious targets and priorities for rural development, environmental protection (rural and urban), energy efficiency (rural and urban context), as well as the need for a home grown innovation society, affecting all sectors. This direction would represent a major step change in China's approach to sustainable development. What do you believe will be the impact on your China business?

The general sentiment among financial institutions is very much a 'wait and see' approach. Generally European banks intend to follow their customers where new markets emerge. However, as one industry representative emphasised, taking into consideration the high capital requirements for each branch, it is unlikely that setting up branches in peripheral areas would yield an adequate return to our investment. Some say they are already working together with local authorities in development projects to develop local credit and savings institutions in rural areas.

One insurance company expected the need to develop a social security system for 600 million city and rural workers to drive forward the insurance market. Currently 50% of these people are not covered by any type of life-insurance presenting a large opportunity for insurance companies to provide this - should the government be serious in building such a social system over the next five years. He expects European insurance providers, with their extensive experience and good track record in newly reformed and reforming economies such as Eastern Europe and Latin-America, to be well positioned to take advantage of their expertise.

However, at the same time, there remains a concern among European financial institutions that the drive west-wards, if not handled correctly, might waste a lot of capital at the detriment of the larger financial system.

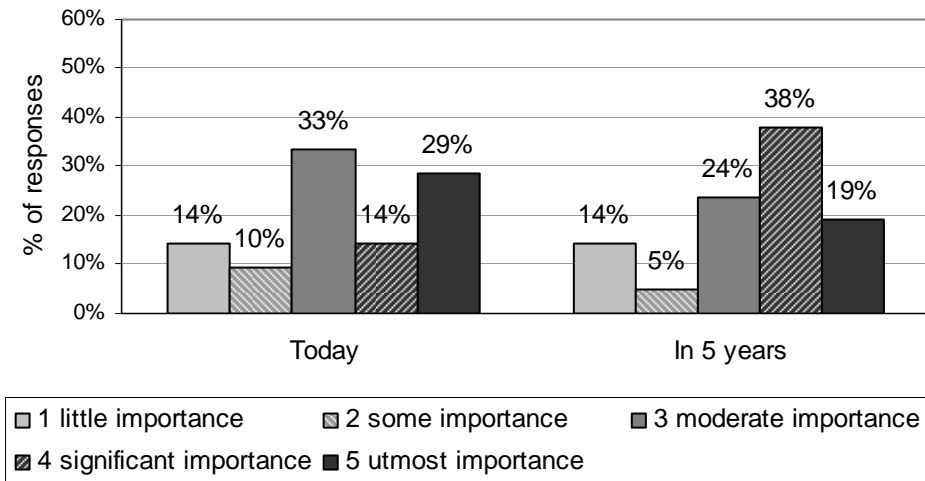
**Table 4 – Opportunities and Constraints Resulting from
China’s 11th 5-Year Programme**

| a) Selected Comments | |
|--|--|
| New Opportunities - Banking | “We hope that the new 11 th Five Year Plan will give us new project financing opportunities for infrastructure and environmental projects. In addition we hope that favourable treatment will be given for opening of new branches in western provinces.” |
| New Opportunities - Banking | “I would agree that the next five year plan is good for EU business, particularly. We follow EU business if the need arises. Therefore if EU business activity increases in China, so will our activities” |
| New Opportunities - Insurance | “The 11 th Five Year Programme and The Standing Committee of the State Council in a recent statement “Some Opinions of the State Council Concerning the Further Reform of the Insurance Industry” identified key tasks for reform of the industry—broaden and improve insurance services, specifically pension, liability insurance, and improve workplace safety and availability of insurance funds to support economic development. These calls show a) that China is assessing the impact of Financial Services development on its overall growth and b) where opportunities and challenges lie. Despite efforts at reforms, the financial system continues to evolve slowly compared to consumer need and the export driven economy. The result is that Financial Services lags behind the manufacturing sector in terms of share of GDP. In the coming years, China will no doubt continue its economic transition from manufacturing to a post-industrial services based economy with the ensuing rise in standard of living/income instead of channeling capital mainly to state controlled enterprises with low productivity. At present level of demand, Chinese households have access to very few financial products and have few investment options. As the services based economy develops, the individual and commercial need for diversified range of financial products will grow commensurately offering huge potential for companies poised to deliver. Here lie the opportunities. The key challenges for insurers will be to convince the Chinese to permit them the flexibility to develop and market, on a non-discriminatory basis, products that meet the current and future needs of the market, in concert with China’s stated objectives” |
| New Opportunities - Insurance | “The need to develop a social security system for 600 million city and rural workers will drive forward the insurance market. Currently 50% of these people are not covered by any type of life-insurance presenting a large opportunity for insurance companies to provide this - should the government be serious in building such a system over the next five years. European competitors have more experience than their US counterparts with operating in newly reformed and reforming economies, particularly in Eastern Europe and Latin-America. This is an advantage due to better experience but also due to a proven track record in this area. Already in Guangdong, which has made an effort to reform its NPSS pool, this insurance company used it’s product but more importantly its good track record in reforming social security systems in other parts of the world to winning significant business in this region. |
| New opportunities for cooperation - Banking | “As an institution we are already involved in development projects by helping the set up of rural investment and saving banks. With the new [11 th Five Year] plan working together with local authorities to develop city commercial banks will become increasingly important in developing rural areas.” |
| b) Selected Comments | |
| Lack of Factor Conditions | “There is less availability of qualified people in western provinces, and of yet no “ target group” for corporate banking” |
| Institutional Weaknesses | “Even bigger than the gap in incomes between the coast and western regions is the gap in caused by institutional weaknesses and corruption. This will make it difficult to develop these regions.” |
| Wasted Capital | “If a lot of capital is wasted on developing the rural regions this might affect the overall stability of the financial system.” |
| Too Few Viable Customers | “Across China competition will become extremely fierce. There are only really a few interesting local corporate customers being chased by far too many foreign as well as local banks.” |
| Unrealistic Time-Scale | “It will need a great many five year plans before it come close to being completed.” |

SECTION 3: CHINESE SECTOR COMPETITION

3.1 How significant is the competitiveness of Chinese financial institutions in your core sectors in the Chinese market? & 3.2 Please describe the nature of Chinese financial institutions' competitiveness within the Chinese market

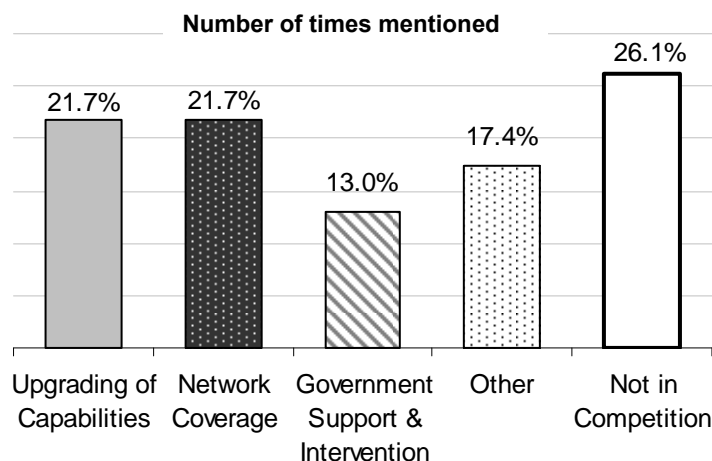
Chart 10- Competitiveness Chinese Financial Institutions in the Chinese Market



Chinese financial institutions are given a high rating in terms of competitiveness within the Chinese market. Their competitiveness is expected to increase on average from an average score of 3.3 to an average of 3.4. Industry practitioners expect the Chinese financial sector to improve its capabilities overall but also expects a more level playing field: The majority (33%) considers that the Chinese financial sector today is at least significantly competitive mainly due to legislative protection. In five years time, 57% of respondents think Chinese enterprises will be at least significantly competitive based more on their indigenous capabilities (see below).

3.2 What are the main advantages your organisation has in China compared to Chinese competitors? Please list in terms of importance (e.g. product/ innovation; brand)

Chart 11- Competitive Strengths Chinese Financial Institutions



Most financial industry representatives taking part in the survey consider it unrealistic to expect foreign banks to dominate the Chinese banking sector. Although Chinese banks currently lag behind in product innovations and technology, the upgrading of indigenous capabilities at Chinese banks is perceived by industry representatives as an important source of competitive

advantage (21.7% of times mentioned). For example, as one industry representative points out, many Chinese banks are currently investing heavily in technology (e.g. CCB in payment & receivables system; China Merchant Bank in credit cards) which opens up new possibilities in product offerings. Of equal importance respondents consider Chinese financial institutions to be competitive due to their network coverage (21.7% of times mentioned). As Chinese banks improve their risk management, respondents believe Chinese banks will be able to leverage their extensive branch network to great advantage. The sheer size of Chinese banks and their host of other local advantages will also benefit their growth. They argue, that Chinese banks will maintain their unassailable position - even if the market was fully liberalised. Chinese banks are also expected to become more internationalised, develop increased relationships abroad, and with their large deposit base of foreign currency will become increasingly active in the foreign exchange markets (Other, 17.4%) although this process is expected to take longer. However, as many representatives comment, Chinese banks still need to solve their more serious governance problems.

It must be noted that around a quarter of interviewees (26.1%) is at pains to point out the cooperative as well as competitive dynamics of operating in the Chinese market, stressing that in many ways the capabilities (and weaknesses) of Chinese and European financial institutions are compatible. In this way, many argue, the capabilities of Chinese financial institutions will on their own and with the help of their respective foreign strategic investors increase, particularly in terms of their service quality and operational abilities.

Table 5 – Competitive Strengths Chinese Financial Institutions

| Selected Comments | |
|---|---|
| Upgrading of Capabilities (1) & Internationalisation | “Chinese banks will become more internationalized. Furthermore I believe that as Chinese companies get listed they would become increasingly under the scrutiny of investors. This should make for a more level playing field. Chinese banks will also rapidly improve their capabilities through their foreign partners.” |
| Upgrading of Capabilities (2) | “Chinese banks are currently investing in technology. Although Chinese banks can adopt some of these ‘of-the-shelf’ solutions they still do not have full solutions. However, these “tech fixes” will not be sufficient if [Chinese banks] more serious governance problems are not solved” |
| Upgrading of Capabilities (3) | “We are optimistic about China’s economic development and on the ability of Chinese financial institutions and Chinese companies to reform. With improvements in corporate governance at many Chinese companies the balance sheets of many banks should also improve.” |
| Advantage of an Extensive Network - Insurance | “We will never obtain the network coverage that Chinese banks have. In future these banks get better (particularly in managing risk) and of course they still have their extensive network. It will be difficult for foreign banks to compete with this. In five years, foreign operators will have gained a larger slice of the market but Chinese competitors will remain dominant. Their continued dominance is ensured because competition remains jurisdiction-based in which it is important to gain a regional license.” |
| “Cooperating to Compete” | “We compete as well as cooperate with Chinese banks. Chinese banks will remain strong in loans (high liquidity means they are keen lenders). If the pricing of loans is liberalised we might even expect difficulties in competing with Chinese banks in this area due to their flexible attitude to loans. We will have far greater advantages in other areas of our business (e.g. asset management & cash management).” |

3.3 What are the main advantages your organization has in China compared to Chinese competitors? Please list in terms of importance (e.g. product/ innovation; brand)

The European financial institutions surveyed see their strengths primarily resting on product offering and innovation⁷⁶ (23% of times mentioned) and their international network (20% of times mentioned), allowing them to serve customers on a global scale, as their key competitive advantages. Their people (i.e. the quality, experience and expertise of their staff) is also cited as an important enabler in maintaining a competitive advantage (13% of times mentioned). Service quality (10%), brand name (10%) and advanced technology (8%) are also factors. The ability to serve home customers better than Chinese competitors through long-term relationships, a better understanding of needs and cultural closeness is a particular area in which respondents believe they will retain their competitive advantage vis-à-vis Chinese financial institutions. Other advantages (8%) include better corporate governance, and ability to exploit niche opportunities, and advantages in foreign currency lending.

Chart 12 - Competitive Advantages of European Financial Institutions in China

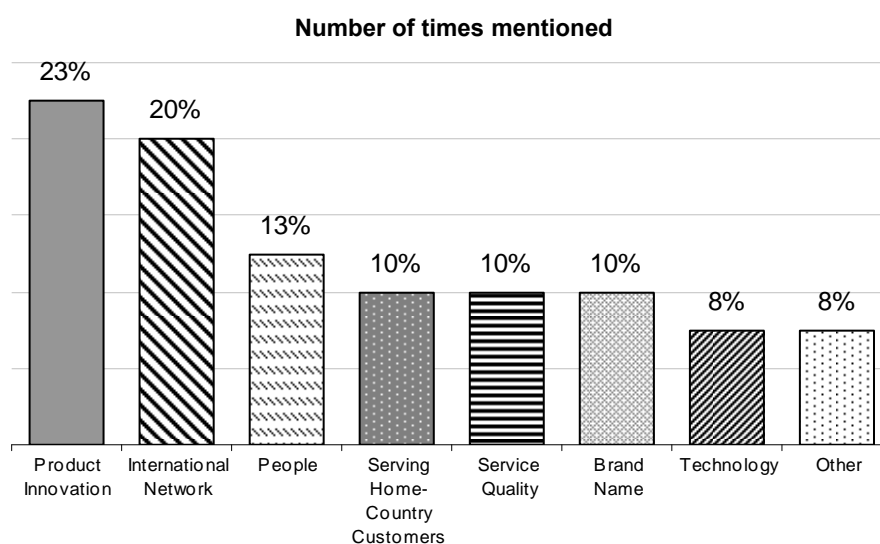


Table 6 - Competitive Advantages European Financial Institutions

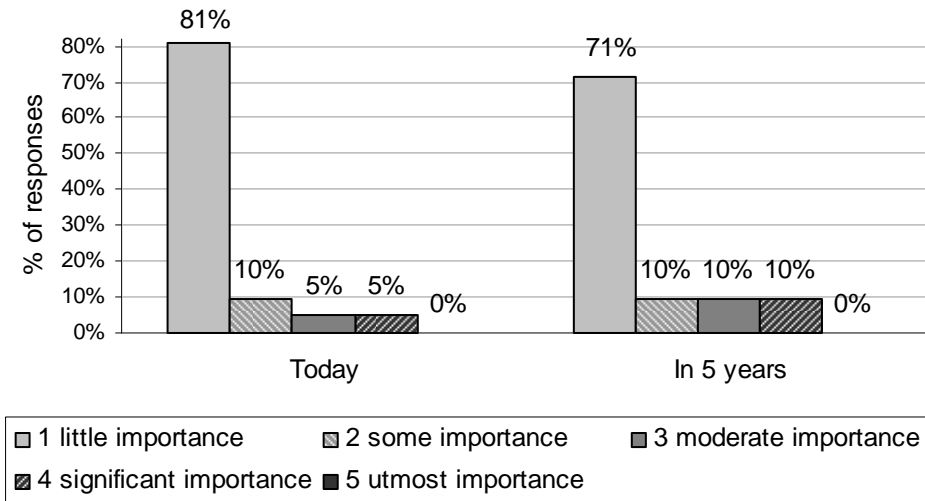
| Selected Comments | |
|---|--|
| Global Network | “Due to our global network we can offer our Chinese corporate customers support in their operations in Europe and the US.” |
| Close Relationship with Home Country Customers (1) | “I think SME’s from our home market will always rely on us providing them with banking services. The market size, i.e. the number of SME’s from our home market entering into China, will continue to grow over the next 5 – 10 years.” |
| Close Relationship with Home Country Customers (2) | “We know our customers, have a long-term relationship with them and speak their language. As our operations in China are mainly as an advisory service we have a better understanding of their customers needs. We then work together with local Chinese banks to offer the product that our client requires.” |

| | |
|---|--|
| Close Relationship with Home Country Customers (3) | “Our target customers are the Chinese subsidiaries of foreign, particularly [home country], companies. Therefore, we do not see much scope for competition with Chinese banks. Our advantages in this market segment will be the cultural factor and a thorough understanding of the company.” |
| People | “Our well-trained team can deliver superior service quality” |
| Foreign Currency Lending | “We have an AA rating which in foreign currency lending allows us not to worry about finding funds.” |
| Niche Market Strategy | “Since we have established ourselves in our niche we are in a much better state, both financially and operationally.” |
| Brand Name and Proven Track Record - Insurance | “Due to a lack of information and regulations a security a product-based approach to expansion is doomed to fail. This is reinforced by a large amount of irrational competition from local competitors which European insurance companies can not adjust to. While European operators do not find it as easy as Chinese competitors to gain licenses for jurisdictions, they have some important advantages in terms of brand-name, but far more importantly in a proven track record.” |

3.3 How significant is the competitive challenge of Chinese financial institutions in your sector within the US market?

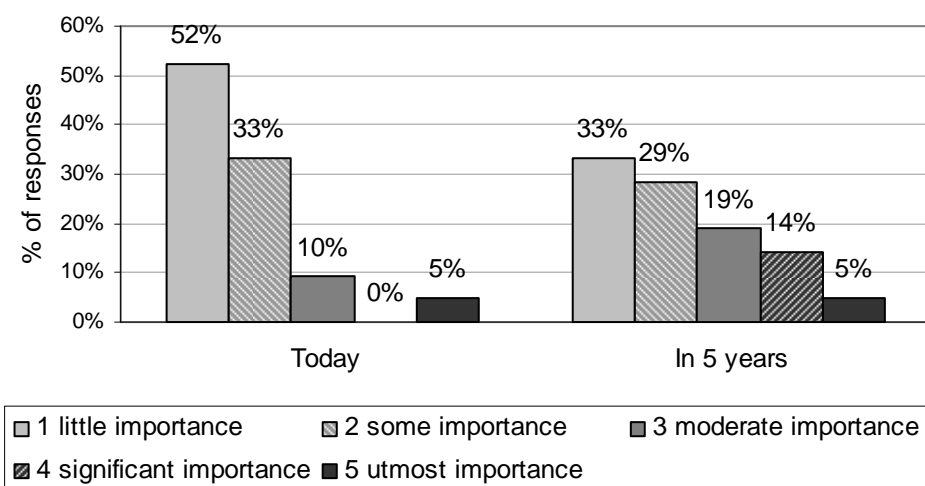
Few survey respondents (20%) regard Chinese financial institutions to be in a position to compete in the Chinese market. The number of respondents who believe the competitiveness of Chinese financial institutions will have at least some significance in five years time increases by only 10 percentage points to 30%. On average this is an increase of only 1.2 to 1.5 on average.

Chart 13- Chinese Financial Institutions Competitiveness in the US Market



3.4 How significant is the competitive challenge of Chinese financial institutions operating in your sector within the ASEAN market?

Chart 14- Chinese Financial Institutions' Competitiveness in the ASEAN Market



Industry respondents do suggest that due to political, geographical as well as cultural proximity, of ASEAN particularly markets such as Hong Kong, Singapore and Thailand will see a higher involvement of Chinese financial institutions than is the case in the US. Currently, almost half (48%) of respondents place at least some importance on the threat of Chinese financial institutions, increasing to 67% in five years time. However, on average the competitive challenge of Chinese financial institutions in ASEAN is rated only 1.6 today, increasing slightly to 2.2 in five years time.

3.5 Please highlight ideas for acceptable investment scenarios in China outside those currently permitted by the Chinese government. Please be creative in considering EU-China win-win approaches to investment and cooperation.

Generally, respondents argue that an increased presence of foreign financial institutions will help improve the sustainability and transparency of China's financial system. Apart from the superior know-how and expertise that would result from increased foreign involvement in China's financial markets, foreign investors can play a key facilitating role in achieving the Chinese government's stated policy objectives. These include reforming the banking sector, bringing much-needed expertise to China's capital markets, and supporting the creation of a viable social security system.

Table 7 - EU-China Win-Win Investment Scenarios

| Selected Comments | |
|------------------------------|--|
| Banking Reform (1) | <p>“We believe allowing foreign investors to own a controlling stake in Chinese banks will create a win-win situation as without us any reforms undertaken will have no effects.</p> <p>I would particularly like to see an improvement in the overall regulatory environment and elimination of the unequal treatment between Chinese companies and ourselves.”</p> |
| Banking Reform (2) | <p>“We believe that allowing foreign investors to own a controlling stake in Chinese banks will create a win-win situation as we believe that without us any reforms undertaken will have no effects. (For example, despite the recent IPO of some Chinese banks they have not floated a majority share – even if they did, shareholding will be too dispersed to make any difference- this means these banks are still controlled by the same local hacks [sic] as previously.”</p> |
| Banking Reform (3) | <p>European banks would benefit from being able to obtain a majority stake in (smaller) Chinese banks. This should benefit a large number of smaller Chinese banks who will gain know-how and new organizational ideas, and should help with the reform of the overall banking sector. [We] think the Chinese need to reform anyway</p> |
| Banking Reform (4) | <p>“To be perfectly frank we would not like the banking sector in China being opened too much. We are a relatively small bank compared with some of our big competitors but we are highly profitable and we would like to keep it that way. If the banking sector was opened too much (e.g. ownership ceiling in Chinese banks lifted) this would not necessarily be good news for us. Probably the biggest banks would start investing heavily and we would have to jump on the bandwagon, something that definitely will cost a lot (if we can afford it) and probably will lose us a great deal of money. Under the current regime of restrictions we can participate with minimal investment and exposure to risk.</p> <p>However, in some other some less significant areas, for example the FOREX regime, we would support liberalisation. We also believe that existing laws should be more equally implemented.”</p> |
| Capital Markets | <p>“Although the capital market has started to open up slightly, bringing in more foreign investment and expertise into the capital market will create a win-win scenario (e.g. stability, improve corporate governance). So far this process has been too slow. In particular we would like the ownership ceiling of asset management companies to be lifted”</p> |
| Capital Markets | <p>“The capital market is slowly opening up. We already hold a QFII [Qualified Foreign Institutional Investor] license and are currently applying for a QDII [domestic] license. However as a bank we are not allowed to operate in the capital markets and has to be done through a securities company.”</p> |
| Capital Markets | <p>“The corporate bond market needs to be more developed, and foreign financial institutions are well placed to aid in this development.”</p> |
| Financial Derivatives | <p>“We believe it would be in China’s favour for financial derivatives and hedging instruments need to be liberalised. This will be beneficial for China as it will help China-based companies to catch-up and compete on the international market as it will increase their set of financial tools that they can use strategically.”</p> |
| Legislation | <p>“If legislation were to become more internationalised this would greatly benefit the Chinese financial system.”</p> |
| More Concessions | <p>“Proportionate use of the ‘stick’ (rather than the charitable ‘carrot’) will have the most effect and the commission must ensure the repercussion for uncompetitive practices must be felt (this is a policy of the Mandelson cabinet which should be built on). Chinese policy-makers are too often given an easy time with the amount of FDI flowing into the country despite a lack of concessions. Of course this is due to the Chinese exclusive ownership of their largest natural resource: 1.3 Bn potential customers. Unfortunately, under current conditions engagement with China is not always a win-win situation for us.”</p> |

ENDNOTES

¹ At the end of 2003, the State Council authorized the use of 45 billion USD of international reserves to boost the capital of Bank of China (BOC) and China Construction Bank (CCB). The capital injection into BOC and CCB was an important step as part of a broader reform strategy for the State-Owned Commercial Banks (SCBs).

² See Dunning (1977, 2001)

³ China made specific commitments in nine out of the 12 major sectors in the classification list generally used by signatories of GATS for scheduling purposes. These are: business services; communication services; construction and related engineering services; distribution services; educational services; environmental services; financial services; tourism and travel related services; and transport services. No commitments were made in health related and social services, recreational, cultural and sporting services.

⁴ Unless otherwise indicated, the section on GATS commitments is based on WTO document GATS/SC/135, 14 February 2002.

⁵ For this application for a subsidiary, a foreign financial institution must have total assets of over 10 billion USD at the end of the year prior to application. For a full-service branch application, institution must have total assets of more than 20 billion USD at the end of the year prior to applying.

⁶ Applying institution must have three years of business operation experience in China and must have been profitable for two consecutive years prior to applying.

⁷ Upon China's accession to WTO the possibility for foreign banks to supply financial services in local currency was restricted to Shanghai, Shenzhen, Tianjin, and Dalian and was then expanded to Guangzhou, Zhuhai, Qingdao, Nanjing, and Wuhan within a year following accession (2002), to Jinan, Fuzhou, Chengdu, and Chongqing within by 2003, to Kunming, Beijing, and Xiamen by 2004, and to Shantou, Ningbo, Shenyang, and Xi'an by 2005. By the end of 2004, 18 cities (the 16 under the GATS commitments as well as Xi'an and Shenyang ahead of schedule) were open to foreign investors supplying financial products in local currency.

⁸ Mode 1: cross border supply; mode 2: consumption abroad; mode 3: commercial presence; mode 4: presence of natural persons

⁹ The investor must be a foreign insurance company with more than 30 years of experience in a WTO member state; it should have had a representative office for two consecutive years in China; and it should have total assets of more than 5 billion USD at the end of the year prior to application (the asset requirements for insurance brokers were set at 500 million USD at accession, falling to over 400 million USD within one year; more than 300 million USD within two years; and over 200 million USD within four years after accession).

¹⁰ Terming this as „prudential regulation“ is required officially, since China in its WTO commitments agreed to skip „non-prudential“ special regulations for foreign banks.

¹¹ Article 92

¹² Including health insurance

¹³ An exception to this is China Minsheng Bank which is majority (60% of shares) owned by private companies, and Shenzhen Development

Bank in which a US investment fund has a de facto controlling stake (see ref 54).

¹⁴ For further details reference is made to chapter 3, “investments” of foreign banks

¹⁵ In recent years, about 560 billion USD of bad loans had already been cleared from the books of Chinese banks, of which 330 billion USD through AMCAs, which took over the bad loans and managed to collect about 100 billion USD

¹⁶ In October 2004, the PBC raised the central bank benchmark interest rates for deposits and lending (for the first time since July 1995), with resulting deposit rates between 0.72% for sight deposits and up to 3.6% for 5 year term deposits, and lending rates ranging from 5.22% for short-term loans to 6.12% for loans with maturities above 5 years. On the lending side, the PBC even scrapped the maximum factor of 1.7 that banks were allowed to overstate the benchmark lending rates, while leaving the minimum factor of 0.9 in place. Thus, banks in principle do not face interest caps on lending anymore.

¹⁷ NPL were officially given with 13 % of total banking loans, thus at roughly EUR 267 billion. Total banking sector equity, in comparison, stood at roughly EUR 115 billion. Even by official accounts, profitability of the banking sector is very low, with an average return on assets (ROA) of 0.43% only with the large commercial banks, while results with unlisted national banks are even worse with a negative average ROA of -0.26% (2004).

¹⁸ Ge Xingjun, head of the Judgment Enforcement Division of the Supreme People's Court, explained that, the main factor leading to the enforcement difficulties in China was local protectionism. Other difficulties include: abuse of power by government officials, frequent policy changes, and lack of laws.

¹⁹ For full survey result please refer to Annex 5.

²⁰ The exact question posed was: “What are the main current obstacles preventing you from expanding further in the Chinese market? Please list in terms of priority?”

²¹ This includes problems such as: drafting and implementation of regulations; transparency of regulation and implementation rules; inconsistent application of legislation; and the constant changes in the Chinese legal environment.

²² Prudential requirements include the minimal capital requirements and high capital adequacy ratios required for setting up new branches.

²³ Licensing restrictions include the need to obtain a license when intending to: set up new branches; conduct local currency business, introduce new financial products such (e.g. financial derivatives, insurance, etc.), foreign exchange trading, capital market participation.

²⁴ Ownership restrictions refer to the investment ceiling of 20% for a single foreign institution and 25% for multiple foreign institutions in Chinese banks, and the requirement to set up a joint-venture in the life-insurance sector.

²⁵ These include cost of capital, non-convertibility RMB, corporate governance practices at Chinese enterprises, corruption.

²⁶ The exact question posed was: “How do you believe these market obstacles will evolve over the next five years?”

²⁷ It must be noted that the model used in this study are based on only rough calculations and cannot claim complete empirical precision nor “inclusivity”. The latter implies that by selecting those areas were opportunity costs due to

restricted market access are assumed to be the highest does not mean that opportunity costs don't arise in other lost business fields as well. Therefore, only the "general tendency" of the models' "predictions" should be taken into account.

²⁸ See Annex 1 and 2 for a more detailed quantification of market obstacles.

²⁹ The progressive development of opportunity costs would be due to the fact that in a few years time European banks could get a very strong foothold on the RMB deposit market, if they had established the required branch network by then.

³⁰ Industrial and Commercial Bank of China (ICBC; BBB+/Stable/A-2) rather focused on the industrial and urban sectors; China Construction Bank Corp. (CCB; BBB+/Stable/A-2) offering long-term loans to construction and infrastructure projects, Agricultural Bank of China (ABC; BBB/--/--) specialized in agricultural and rural loans and deposits, and Bank of China Ltd. (BOC; BBB+/Stable/A-2) focusing on foreign exchange and international transactions.

³¹ Bank of Communications (BOCOM; BBB-/stable/--).

³² Agricultural Development Bank of China, which finances the purchase and storage of crops from farms and agriculture-related capital investments; China Development Bank (also known as State Development Bank of China), which provides funding for state-supported infrastructure and technology projects; and Export-Import Bank of China, which promotes strategic international business and trade.

³³ Bank of Communications, China CITIC, China Everbright Bank, China Merchants Bank, China Minsheng Bank, China Zheshang Bank, Evergrowing, Guangdong Development Bank, Hua Xia Bank, Industrial Bank, Shanghai Pudong Development Bank, Shenzhen Development Bank, China Bohai Bank

³⁴ Bank of Beijing (ING and IFC), Bank of Shanghai (HSBC, IFC and Shanghai Commercial Bank), Hangzhou City Commercial Bank (Commonwealth Bank of Australia), Jinan City Commercial Bank (Commonwealth Bank of Australia), Nanchong City Commercial Bank (KfW), Nanjing City Commercial Bank (IFC, BNP Paribas), Ningbo City Commercial Bank (Bank Oversea Chinese Banking Corp.), Tianjin City Commercial Bank (Australia & New Zealand Banking Group), Xi'an City Commercial Bank (IFC, Bank of Nova Scotia)

³⁵ The six holding companies are China People's Insurance Holding Company (PICC), China Life Insurance (Group) Company, China Reinsurance (Group) Company, China Insurance Holding Company, China Pacific Insurance (Group) Company Limited and China PingAn Insurance (Group) Company Limited.

³⁶ The company was originally formed as "Unibank", a department of the People's Bank of China. During the period up to 1985, there was essentially no insurance industry in China and the sector was revived in 1985 through the establishment of Unibank as an independent company, the PICC.

³⁷ Willis Pudong Insurance Brokers Ltd. (2004).

³⁸ In 1991, 76.8% of insurance premiums generated in the market were from non-life insurance. The life market, with a mere RMB 4 billion in premiums, made up only 23.2% of the market. By 2004, the positions were almost reversed, with life insurance accounting for 74.6%,

and non-life insurance accounting for 25.4% (excluding reinsurance to avoid double counting).

³⁹ IFC had bought 15% in 2001, and then sold 10% to BNP in 2005.

⁴⁰ Allianz is traditionally an insurance group, but also owns Dresdner Bank, a large German bank.

⁴¹ A previous investment by Aetna (USA), which sold its international business in 2000 to ING (Europe)

⁴² AIA, fully owned by American Investment Group (AIG), is the only fully foreign-owned life-insurance company in China. Additionally, AIA holds a license for non-life insurance. After its foundation in Shanghai in 1919 it was the first foreign insurance company returning to China with the beginning of reforms. AIA is in a unique position compared to other foreign insurance providers, which can operate the life-business only with Chinese partners, and which cannot operate both life and non-life insurance with the same entity.

⁴³ Only in lending in foreign currency, foreign banks hold a significant market share of about 20%.

⁴⁴ In 2000 concentration processes in EU started, for instance in France, Italy and Germany and UK with an average of M&A of banks of over 10 per year, in France even over 20. In EU 25 in total an average of more than 60 mergers since 2002 were registered, in 2001 even 93. Still, the density of banks per inhabitant is rather high in the EU, allowing for potential mergers effectuated also by foreigners, which are, however, difficult to implement successfully.

⁴⁵ Based on the Glass-Steagall Act, which made banks to do either investment banking or commercial banking business.

⁴⁶ For more details on this survey please refer to Annex 5.

⁴⁷ Although some Chinese banks enter the European financial markets to follow their existing customers, Chinese banks will in future mainly seek to gain access to local financial expertise and institutions rather maintaining or even gaining new customers

⁴⁸ Despite fulfilment of WTO rules by end 2006, there are still significant restrictions for foreign banks and insurance companies in place, as depicted in the study.

⁴⁹ Moderate growth under Chinese conditions, however, is still modelled quite strong. But the growth modelled here is lower than expected by some optimists.

⁵⁰ This assumption is justified, as it is only likely that the Chinese government would be willing to concede market share to foreign institutions by liberalising the financial sector under very favourable growth conditions. Alternatively, with a lesser degree of foreign participation the financial sector is expected to grow less fast in the first instance

⁵¹ "Deposits" here include not only classic RMB deposits (which are expected to grow at only 2%), but also other and more attractive forms of depositary and savings products

⁵² Share in banking sector assets as proxy for averaged market share across major business areas. In practice, EU banks for example have a negligible market share in RMB loan and deposit markets, but some considerable market shares in foreign currency denominated lending and in trade finance.

⁵³ Roughly 40% of all foreign banks' market share, measured in banking sector assets, of 2%

⁵⁴ Limited market shares in particular in the very important RMB loan and deposit markets can only partly be offset by higher market shares in foreign currency products and other, more sophisticated sub-markets.

⁵⁵ "Deposits" here include not only classic RMB deposits (which are expected to grow at only 8%), but also other and more attractive forms of depository and savings products.

⁵⁶ In the latter two cases, the International Finance Corporation (IFC) holds another 5% and would certainly be willing to sell this stake to ING or BNP respectively at a later stage.

⁵⁷ Since Newbridge Capital is an investment fund and not a bank, the expectation is that they would at a later stage want to sell their almost 20% stake to another foreign bank in order to realize a profitable "exit" from this investment.

⁵⁸ China's WTO commitments in the area of insurance brokering is relevant for large scale commercial risk insurance and reinsurance, and international marine, air transport, and transport insurance and reinsurance. Other brokerage services are not covered by the WTO commitments ("unbound").

⁵⁹ Apart from these formal obstacles there are also a number of informal barriers for foreign insurance providers such as the behaviour of the regulator in approving new products and formulation of new rules

⁶⁰ Officially, these specific regulations for foreign banks are of a prudential nature and therefore not against China's WTO commitments. It is perhaps ironic however that, considering the state of Chinese banks Chinese regulators can argue that they have to be more "prudential" with foreign than with Chinese banks.

⁶¹ The author would like to thank Barry Livett of the EU-China Financial Services Co-operation Project for his insight into recently adopted regulations. Any opinions derived from this legislation are the author's own. For further detail see:

<http://www.mallesons.com/publications/2006/Nov/8696677W.htm>

⁶² This end-loaded growth path is assumed since RMB deposit business would rise with the build-up of a branch network. In the second half of the period, a "jump" is expected, since with the first bankruptcies of Chinese banks depositors' trust should swing towards foreign banking institutions.

⁶³ This end-loaded growth path is assumed since RMB lending would rise with the build-up of a branch network. Although foreign banks are increasingly well represented in major commercial cities, they need to build-up branch networks in order to reach more remote customers.

⁶⁴ The rather low "average margin" for the period 2006-2010 is assumed, since with the growing convertibility of the RMB a decreasing general demand for foreign currency loans is expected.

⁶⁵ This end-loaded growth path is assumed since insurance premiums would take-off if a larger distribution network is in place.

⁶⁶ Including health insurance.

⁶⁷ This end-loaded growth path is assumed since insurance premiums would take-off if a larger distribution network is in place.

⁶⁸ These percentages have been rounded to two significant numbers.

⁶⁹ These percentages have been rounded to two significant numbers.

⁷⁰ This includes problems such as: drafting and implementation of regulations; transparency of regulation and implementation rules; inconsistent application of legislation; and the constant changes in the Chinese legal environment.

⁷¹ China's State Administration of Foreign Exchange

⁷² Prudential requirements include the minimal capital requirements and high capital adequacy ratios required for setting up new branches.

⁷³ Licensing restriction include the need to obtain a license when intending to: set up new branches; conduct local currency business; introduce new financial products such (e.g. financial derivatives, insurance, etc.), foreign exchange trading, capital market participation.

⁷⁴ Ownership restriction refer to the investment ceiling of 20% for a single foreign institutions and 25% for multiple foreign institutions in Chinese banks, and the requirement to set up a joint-venture in the life-insurance sector.

⁷⁵ These include cost of capital, non-convertibility RMB, corporate governance practices at Chinese enterprises, corruption.

⁷⁶ It must be noted that in the context of the insurance industry in particular, European operators complain that they cannot take advantage of their superior product innovation and asset management, resulting in the only differentiation possibility being distribution – an area in which foreign operators are not able to compete.