



TRADE SUSTAINABILITY IMPACT ASSESSMENT FOR THE NEGOTIATIONS OF A PARTNERSHIP AND COOPERATION AGREEMENT BETWEEN THE EU AND CHINA

Sectoral Study 3 of 5: Financial Services

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1. Background

1.1 Global Competitive Context

The way that institutions are designed in support of financial sector development has an important impact on economic growth. This applies to the improved allocation of savings through pooling and market-based pricing of credit and other types of risks and, in an international context, benefiting from access to world financial markets with increased economies of scope and scale. The substantial cross-border capital movements that exist today have been created through countries' liberalisation of their financial sector, underpinned by technological advancements coupled with financial innovation.

Banks have responded to these enabling conditions by shifting from national banking operations towards a transnational banking strategy. A global trend in this direction, starting initially among banks in advanced economies, has been discernable since the mid-1980s. Today, consolidated banking figures show that European banks are among the most transnational in the world.¹ As the shift from a national to transnational financial system has developed, the motivations for European banks to expand from mature markets at home to countries such as China indicates further changes in the financial landscape of emerging markets.

The increasingly important role of emerging markets in the international financial system has brought important global benefits but it has also increased the risks of financial instability adversely impacting the region or country affected. The experience of the Asian Financial Crisis (1997-1999) remains an important consideration in Chinese policymakers' decision making. Although China was shielded by the full effect of the crisis in South East Asia and South Korea, GDP growth slowed down in 1998 and 1999. During the crisis the Chinese economy was protected by a closed capital account and the fact that China's foreign investment was mainly in fixed assets (i.e. factories) rather than securities, shielding the country from rapid capital flight.

Nonetheless, the experience of the Asian financial crisis also reinforced the need for China to resolve its financial weaknesses. This has further encouraged Chinese policymakers to make progressive moves to address the weaknesses in productivity and profitability of Chinese financial institutions, notably in reducing the amount of Non-Performing Loans (NPLs) on banks' balance sheets. At the same time China agreed to open up its financial sector, forcing local banks to accelerate banking reform and encourage them to meet international standards. Since China's WTO accession in 2001, this has enabled foreign banks to increasingly participate in China's banking sector (see **Table 1**). Given their finance-related technical skills and sophisticated service provision, this opening up recognises that foreign banking services have a role to play in a maturing economy where demand for services in retail banking, commercial banking and residential mortgages are rapidly undergoing change.

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 conduct of foreign currency business with regard to commercial presence in China -Foreign currency services can be supplied to all types of clients -Abolishment of any existing non prudential measures restricting ownership, operation, and juridical form of foreign financial institutions, including internal branching and licenses

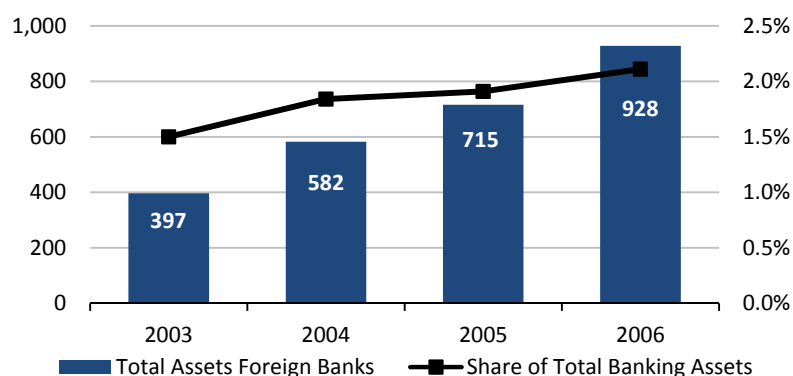
¹ Data on international consolidated banking statistics can be found on <http://www.bis.org/statistics/consstats.htm>

The beginning of 2006 marked the official opening of China’s banking sector to foreign banks. In anticipation of this, foreign banks invested over US\$11 billion in 2005. Since then, the entrance of foreign players and the transition to a more market-based mechanism in China is taking place amidst a backdrop of heightened concerns about global liquidity and credit risks following the sub-prime mortgage crisis which started in the US in late 2006. In addition to the commercial restraints this backdrop has put on foreign banks, these developments also increase the short-medium term challenges for China’s banking regulators to further open up the Chinese market.

1.2 EU-China Specific Sector Context

Apart from the central bank, the People’s Bank of China (PBOC), the Chinese banking system consists of three tiers. The State Development Bank, Import and Export Bank, and Agricultural Development Bank are policy banks, which were created in 1994. Since their inception, their mandate has been to provide investment financing to central government projects and to fulfil the state’s grain procurement plans. The second tier comprises what are known as the four state-owned commercial banks (SOCBs): Agricultural Bank of China (ABC), the Industrial and Commercial Bank of China (ICBC), the Construction Bank of China (CBC, formally People’s Construction Bank of China), and the Bank of China (BOC). The third tier consists of joint stock commercial banks, city commercial banks, rural credit cooperatives and foreign banking institutions. In 2006, the market share of the SOCBs and Joint-Stock Commercial Banks was 55 percent and 12 percent respectively of the overall banking sector assets.² However, the assets share of the four SOCBs has been declining slightly, as Joint-Stock Commercial Banks and foreign banks gradually gain market share.

Figure 1: Market Presence of Foreign Banks in China (RMB bn)



Source: CBRC (2007)

As of October 2007, 25 foreign banks had been incorporated locally, and they had established 133 direct branches in China. European banks opened 46 direct branches of which four were subsidiary banks with 27 local branches.³

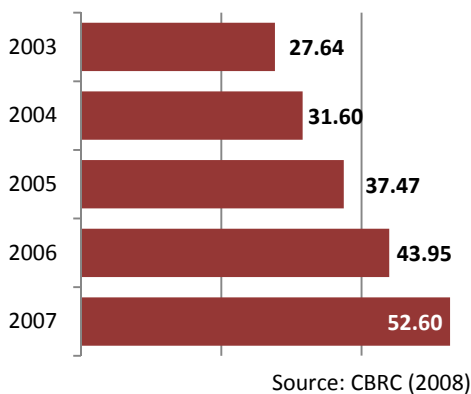
² CBRC Annual Report (2007)

³ “WTO Discusses China’s Financial Services Commitments”, Kanaga Raja, 13 November 2007; The low number of subsidiary banks is due to the law/regulation on foreign funded banks which gives preference to locally incorporated subsidiaries (of foreign banks) over branches (of foreign banks), in particular as concerns the possibilities to perform RMB deposit business. Since a strong RMB deposit business is extremely important also for the foreign banks’ lending business – due to the maximum loan to deposit rate of 75% (see below) – EU banks in China will have to set up more locally incorporated subsidiaries instead of only setting up branches.

In terms of assets, by the end of December 2006, the total assets of foreign banks in China added up to around RMB 928 bn (€ 92.85 bn), an increase of 29.8% over the previous year (**Figure 2**). Overall profits for foreign banks in China have also increased, rising from RMB 1.66 bn in 2003 to 5.77 bn in 2006.⁴

Foreign insurance companies have also grown their presence within the Chinese market. China reported that by the end of May 2007, there were 46 foreign insurance companies in China with 130 operational branches reaching profit levels of over RMB 14.21 billion (€ 1.42 bn) in 2006, which was 4.24 times higher than it was at the time of China’s accession. In addition, about 200 representative offices had been set up by 135 foreign insurance institutions.⁵ In the securities sector China has approved, by the end of September 2007, eight joint-venture securities companies and 28 joint venture fund management companies.⁶

Figure 2: Total Assets of Chinese Banking Institutions (RMB Trn)



For the time being, China’s continued economic boom is reflected in the growth and increasing profitability of its financial sector. The combined profits of China’s 17 major commercial banks reached RMB 298.7 billion (€28.7 bn) in 2007, with combined banking sector assets amounting to RMB 52.6 trillion (€5.06 trn), more than twice the amount of total assets in 2002 (**Figure 1**). During this time, the non-performing loan ratio dropped to 6.7 percent, down from 23.6 percent in 2002.⁷

There are some doubts and discussions about the accuracy of these non performing loan figures.⁸ The significant reduction in the NPL shares of Chinese banks is not only because loan portfolio quality has increased, but that significant amounts of NPLs had been sold to specialised Asset Management Companies (AMCs). This would mean better quality of balance sheet assets of Chinese banks, but the sale of NPL portfolios far below book-value would then have created losses for the banks. One indication of this is that during 2004-2006 193 transactions took place, during which Chinese AMCs further sold on NPL portfolios worth about US\$ 24 bn to specialised foreign investors.⁹ Assuming, as an example, that Chinese NPLs on average were sold at 20 performance of their book value, and then this alone would have corresponded to NPLs “formally worth” US\$ 120 bn sold alone to foreign investors during 2004 and 2006. As Chinese financial institutions increasingly take larger stakes in foreign banks (e.g. Ping An’s 50% acquisition of Fortis in early 2008), concerns over the potential economic and political implications appear to be rising, with senior Chinese investment managers making efforts

4 CBRC Annual Report (2007)

5 “WTO Discusses China’s Financial Services Commitments”, Kanaga Raja, 13 November 2007

6 *Ibid*

7 ‘Banknotes Newsletter’ (KPMG, 25.01.2008) Available at: http://www.kpmg.com.hk/en/virtual_library/Financial_services/bank_notes/Banknotes080125.htm ;

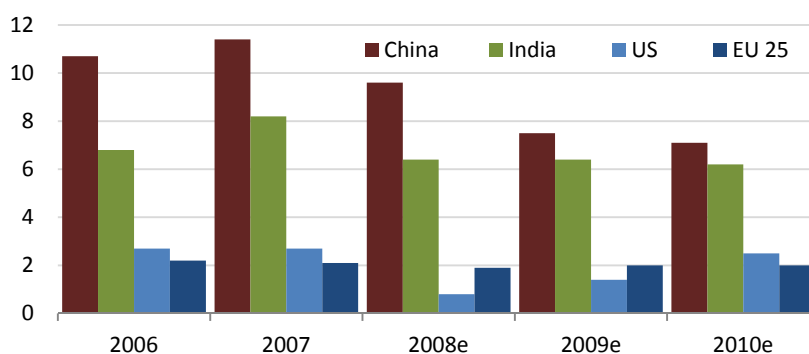
8 Ernst & Young, a professional services firm, in May 2006 had first reported total NPLs in Chinese banks to be at US\$ 911 bn, and later withdrew this report as “erroneous”. There are those in the financial sector community who believe that this report was withdrawn for “political” or business reasons. In addition, an important reason that the NPL ratio has dropped is the strong growth in new credits issued and accordingly the strong growth in overall outstanding credit volume. Overall outstanding credit volume grew by 15% during 2006 (2005: 10% and 2004 12%). (Source: PBOC, China Financial Stability Report 2007, page 138). By their nature, NPLs “show” only when the respective loans mature. Thus, NPL rates might rise again, since even Chinese banking supervisors warned of a lack of risk consciousness of Chinese banks when issuing mortgage loans. (Source: KfW Research MacroScope, China: Wirtschaftsboom sieht sich Herausforderungen gegenüber; no. 24, March 2007)

9 PwC NPL report Asia, Issue 8, March 2007

to stress their actions towards increasing transparency in China’s financial sector.¹⁰

In the meantime, however, China’s continued status as the world’s fastest growing major economy for the foreseeable future (**Figure 3**), will ensure that both domestic and foreign financial institutions continue to benefit as China’s financial sector continues to grow. Although the expected weakening of global growth in 2008 will affect China’s economy, Chinese financial institutions have a relatively low direct exposure to US sub-prime securities, and the direct effect of the US sub-prime problems via balance sheets will therefore be relatively small.¹¹ There are expected to be important indirect effects, since shortly before the outbreak of the sub-prime crisis Chinese state-based investors had made significant investments in globally acting financial institutions, which subsequently substantially lost in value due to the falling share prices of these institutions in the wake of the sub-prime crisis.

Figure 3: Global GDP Growth Rates Compared (%)



Source: IMF, ADB, World Bank (2008)

Market Entry Obstacles for Foreign Financial Institutions

Despite the opening up of the financial sector that has followed China’s entry to the WTO, regulations and licensing requirements for foreign banks remain stringent. While the number of foreign banks participating in China’s financial sector has grown, the nature of their business practices and depth of investments still remains limited. **Table 2** outlines an inexhaustive list of the most notable market access obstacles facing foreign banks in China.

Table 2: Notable Market Access Obstacles for Foreign Banks in China

Differentiation of branches of foreign banks vs. locally incorporated subsidiaries of foreign banks	<p>While in principle foreign banks are now allowed to do RMB business, there is a new differentiation between “branches of foreign banks” and “locally incorporated subsidiaries of foreign banks”. “Branches of foreign banks” cannot:</p> <ul style="list-style-type: none"> - provide RMB loans to Chinese citizens (individuals) - offer retail deposits to Chinese citizens – they can only offer time deposits to Chinese citizens of at least RMB 1 million (approx. €95,000) per deposit, and are thus practically barred from the RMB deposit business with (non wealthy) individuals - cannot offer card business
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10 In March 2008 Ping An Insurance (Group) Company of China, Ltd and Fortis jointly announced the intention of Ping An to take a 50% stake in Fortis, worth over €2.15 bn. In June 2008 Gao Xiqing, chief investment officer of the China Investment Corporation (which is unrelated to Ping An) stated that government transparency was contrary to the nation’s historical precedent.

<http://www.ft.com/cms/s/0/50946dc8-3198-11dd-b77c-0000779fd2ac.html>

http://www.fortis.com/shareholders/media/pdf/UK_Fortis_Ping_An_Investments_Press_Release.pdf

11 World Bank Quarterly Update February 2008

	Locally incorporated subsidiaries of foreign banks are not subject to these restrictions, and thus in their RMB business are basically treated like Chinese banks.
Branch/ Sub Branch Network Expansion	Foreign banks continue to face difficulties due to a complex system of administrative submissions required to expand their branches and sub-branches network. This process is made particularly time consuming as foreign banks are currently not allowed to make simultaneous multiple branch and sub-branch submissions.
License Requirements for New Products and Services	There are no clear implementation guidelines on the issuance of new financial product introductions such as credit and debit cards. All banks with local incorporation are still required to seek approval of local authorities for all new product or services initiatives. As products become more complex this prevents the consistent and efficient launches of new financial products.
Capital Requirements	For locally incorporated subsidiaries of foreign banks, the capital requirements have again been set higher than before, from RMB 300 million (28.5 million €) to RMB 1 bn (95 million €). On the other hand, once established, locally incorporated subsidiaries of foreign banks can open new branches with less branch operating capital – RMB 100 million (€9.5 million) instead of previously RMB 300 million (€28.5 million). Although according to Chinese banking regulations, ¹² local banks are submitted to the same rules as foreign banks ‘second-tier’ sub-branches from SOCBs are often exempt of the same RMB 10 million capital requirements. This can be contrasted with the € 5 million capital requirement for banks to operate throughout Europe.
Foreign debt quota	Most foreign invested enterprises (FIEs) do not have sufficient debt quotas. These foreign debt quotas hamper the ability of FIEs to source funding from their relationship bank in China, many of whom are foreign banks.
Ownership Restrictions	Foreign banks are not permitted to hold more than 20% individually (25% collectively) of a Chinese bank.
Securities and Fund Business	Despite China’s accession to the WTO this sector remains largely closed to foreign competition. Currently no foreign majority-owned securities firm or fund management company exists in China. The amount of securities business done by the seven foreign invested joint-venture securities firms ¹³ remains small. Foreign companies are not allowed to hold majority control in fund management companies.
Bond Underwriting	Currently foreign banks can only buy/sell domestic bonds on proprietary basis and are barred from selling on to end investors.

¹² Administrative Rules of Commercial Banks Outlets 11/March/2002 promulgated by the People’s Bank of China

¹³ As of end 2007: <http://www.csrc.gov.cn/n575458/n4001948/n4002195/n4003695/n4003770/n4003830/9430854.html>

Prudential Requirements (Very Low Maximum Loan-to-Deposit Ratio)	Among rules which apply to both local as well as foreign banks is a very low maximum loan-to-deposit ratio of 75%, implying that a bank with 100 units of deposits cannot have outstanding more than 75 units of loans. This in principle is a “prudential regulation” to ensure the liquidity of banks, and thus not forbidden under WTO rules. But given that foreign banks find it hard to gather significant amounts of RMB deposits, their lending business will also remain limited. Since foreign banks, however, only have to fulfil this regulation by 2011 it remains to be seen how well they will cope with it, i.e. how much RMB deposits they manage to attract. Given the slow regional expansion and branch office opening procedures already mentioned, it won’t be easy for foreign banks to fulfil this ratio in time. If the loan-to-deposit ratio had applied to foreign banks by early 2007, foreign banks would have had only about half the volume of deposits required to cover for their then existing loan portfolio – in other words, they had a loan-to-deposit ratio of approx. 150%. The current loan-to-deposit ratio of max. 75% set in China is another incentive to transform branches of foreign banks into locally incorporated subsidiaries (with higher capital requirements), in order to have better access to the retail/individual deposit market.
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Source: EUCCC Position Paper 2007/2008; EMG Analysis

These market obstacles illustrate that while China is eager to find foreign minority investors for Chinese banks who bring 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 long term, regulators remain hesitant to expose domestic banks to the full brunt of foreign competition.

Additional Impediments to Financial Sector Competition

In addition to the market access obstacles listed above there are weaknesses to China’s business environment which restrict competition in financial sector.

Public Ownership and Control

Financial intermediation is still mainly done through a highly concentrated and state owned banking sector. Notwithstanding different governmental steps (reforms such as in the field of supervision, auditing, minimum capital requirements, foundation of Asset Management Companies (AMCs) to “outsource NPLs”¹⁴, capital injections in major banks by the state, etc.), it remains difficult to find clear evidence that the SOCBs have substantially changed their behaviour and have become truly commercially oriented.

Another example of high levels of public ownership and control are the capital markets. Out of the 1,378 (2005) listed companies on China’s two domestic stock exchanges, 71.6% were state-holding companies. Only 36% of all shares in listed companies are tradable, and of the almost two thirds of the shares that are not tradable and within these two-third are owned (“controlled”) by the state, which indicates a lack of distinction between the state’s role as a shareholder and regulatory with according “conflicts of interest”.

¹⁴ In recent years, about US\$560 billion of bad loans had already been cleared from the books of Chinese banks, of which US\$330 billion through AMCs, which took over the bad loans and managed to collect approximately US\$100 billion

On the deposit side, banks still have to operate within the benchmark rates set by the PBC. 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 attract deposits. The notionally large market of the Chinese “savings pool” remains largely inaccessible by foreign banks.

Weaknesses in the Financial Sector

The limited role of capital markets not only limits refinancing possibilities for financing institutions, e.g. when entering in RMB business, but also does not allow for more efficient pricing of credit risk, strengthened management of financial risk, etc. Equity and bond markets are still relatively underdeveloped and do not respond to the financing needs of the developing private sector. Foremost, competition with regard to capital markets is hampered, since intermediation is dominated by the state banks, while at the same time these markets continue to be plagued with regulatory and governance problems.

Anti-competitive Banking System Quality

Since the introduction of a consistent loan classification system several years ago, progress in reporting NPLs has increased, but seemingly an adequate transparency and risk culture remains improvable. The quality of disclosure in other areas remains poor and the information risks remains high. Also 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 or capitalising them as losses. Since the 1990s, many regulations in this respect have been initiated, such as accounting policies which in theory are fairly consistent with the basic concepts of the International Accounting Standards.

Discrimination in Trade Finance with Chinese Companies

All foreign currency trade finance facilities undertaken by Chinese trading companies are subject to state approval. The approval process for issuing such facilities is more tedious for foreign banks since every such facility is individually considered as “foreign debt of China” and therefore needs specific approval. A new regulation has been planned, however, to consolidate the “foreign debt of China” definition with the balance sheet of the foreign banks, which would allow equal access to foreign and Chinese banks.

Insurance-Specific Obstacles

Multimode operations

Under Chinese Insurance Law,¹⁵ 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, that in their home market usually provide both life and non-life products, from realising internalisation advantages.

Non-Life Insurance

15 Article 92

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 conduct insurance business. Motor insurance, which is a particularly significant segment of non-life insurance, will continue to face additional restrictions. Furthermore, foreign insurers are not entitled to write policies for compulsory third party liabilities, and where 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”, Chinese insurance companies can obtain new licenses for several branches at the same time in practice.

Life Insurance¹⁶

Foreign companies are only allowed to do business in joint ventures (JV) with Chinese companies and may not hold more than 50% of the shares of the JV, while sharing the management of the JV with their Chinese partner. Since 2005 they may also write group policies, health or pension policies, but given the strong networks between Chinese insurers, this market will remain difficult to tap.

Geographical Licensing Approvals

Currently the criteria for admitting foreign insurers into regional markets are not completely transparent. There remains a lack of established criteria in the development of new regional markets. This means that the speed and priorities of geographical expansion is not determined by business considerations remaining to a large extent in the hands of local regulators.

¹⁶ Including health insurance

2. Baseline Trends

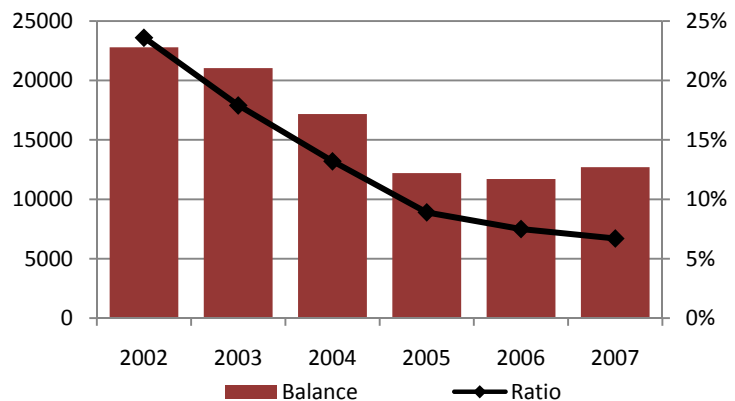
2.1 Economic Trends

As the Chinese economy continues double-digit annual growth, the banking sector plays a crucial role in maintaining and handling such growth, amidst fears of overheating and inflation. In 2007, the economy grew by 11.4%, and inflation was at a 11-year high at 8.1%.¹⁷ As China's economy is boosted by exports and fiscal stimuli in the form of spending on infrastructure, its engagement with the rest of the world, especially in light of its WTO commitments, has the potential to further propel the economy's growth. By reforming its financial sector, China is expected to generate \$130 billion in the period between 2004 and 2010.¹⁸

The Relationship between China's State Owned Enterprises (SOEs) and NPLs

Through their historical links to the state banks, SOEs consume much of China's capital, though they produce little or no returns on their loans. By providing non-performing loans (NPLs) with little regard for repayment or risk, the portfolio of non-profitable loans has been as high as 25% in 2001. Chinese authorities have managed to maintain liquidity by using its stock of foreign reserves. If uncontrolled, NPLs can result in the restriction of bank credit provision, limiting the growth of businesses. Current trends are positive, suggesting changes in the lending policies of banks, as the average NPL ratio fell to 6.7% at the end of 2007, compared with 23.6% five years ago.¹⁹ However, these figures may conceal the fact that while the ratio of NPLs continues to fall, the total NPL balance of commercial banks has rebounded.²⁰

Figure 4: NPLs at Major Chinese Commercial Banks (RMB bn)



17 National Bureau of Statistics of China, 2007

18 BCG Report May 2006

19 China Economic Review, 25 January 2008

20 ChinaStakes.com, 17 February 2008; It is not excluded that the reduced stock of NPLs "on the balance sheets" of Chinese banks has more to do with the fact that they sold off significant parts of the NPL portfolios to specialized Asset Management Companies (AMCs). There are only estimations at the total volume of such transfers made: in the first round in 1999 the AMCs are said to have taken over NPL portfolios of RMB 1,400 billion (USD 170 billion) from Chinese banks. Estimations for further sales of NPL portfolios from Chinese banks to AMCs during 2004/05 are at RMB 1,225 billion (USD 153 billion) (source: PwC NPL report Asia, Issue 8, March 2007). Assuming, for example, that NPL portfolios had been sold from banks to AMCs for on average 20% of their book value, the estimated 2004/05 sales would then correspond to about RMB 6,125 billion (USD 765 billion) reductions in NPL book value in bank's balance sheet (again assuming that before the sale, the loans had still been booked at face-value, and had not been partially written-off before). Summarising, although credit portfolio quality could be increasing among major Chinese banks, it is very difficult to judge how good (or bad) credit quality in Chinese banks really is.

The precarious financial state of the Chinese banking system has made Chinese reformers reluctant to open the banking sector to foreign competition. Reform of the financial sector will mitigate one of the main problems faced by SOCBs - the large volume of NPLs, which place a substantial burden on the balance sheets of at least half the banks in the financial system. Fears of displacing employees in SOEs are one of the reasons that regulators have resisted changes in the sector. However, in the long term, a more efficient and market-based system is necessary to ensure stability and higher levels of employment.²¹ Net losses of jobs are likely to be negligible as a booming private sector market will be able to offset job losses in SOEs. The recent experience of China's auto industry attests to this phenomenon, as restructured SOEs shed many jobs, but overall employment levels in the industry still increased.²²

To promote long-term economic growth, reforms that allow foreign competition and private sector development through a fully functional capital market, are necessary. Instead of maintaining the status quo which perpetuates government control and ownership, a genuinely commercial banking sector that is rules-based will not only help reduce the burden on the banking sector caused by NPLs, but will also align China's financial system with that of the needs of an emerging and dynamic private sector.

The growth of the private sector SMEs

China's current rate of economic growth provides a fertile ground for the further development of small and mid-sized enterprises (SMEs) requiring banking services. SMEs are now estimated to be responsible for about 60% of China's industrial output and employ about 75% of the workforce in China's cities and towns.²³ As a result of favourable lending policies for SOEs, the SME market is left under-funded and European banks can help fill the gap. According to a survey of more than 600 enterprises in Sichuan province conducted by the China Project Development Facility (CPDF), a multi-donor facility managed by the International Financial Corporation (IFC) aimed at helping SMEs, it was discovered that banks supply less than 10% of the investment capital needed by enterprises. In comparison, a 2003 World Bank survey on China's investment climate discovered that Chinese SMEs received 12% of their working capital from banks. The corresponding figure in Malaysia was 21%, 24% in Indonesia and 26% in South Korea and Thailand. These figures suggest that for SMEs to contribute further to China's economic growth, the support of banks, in terms of loan provision, is a vital factor.

More recent and notable examples of efforts that have been made to improve access to finance by SMEs through capital markets suggest an emerging trend with positive implications. In November 2007, the first "SME bundled bond" was issued. "SME bundled bonds" are bonds of different firms bundled together by the China Development Bank into a bond that is treated as one bond by the NDRC, the regulator. The bond was issued by 20 SMEs jointly, while each bears their own repayment obligation. It was underwritten and

21 'How Financial System Reform could Benefit China', McKinsey Quarterly, 2006 Special Edition

22 'How Financial System Reform could Benefit China', McKinsey Quarterly, 2006 Special Edition

23 US Embassy, 2002, Source <http://www.usembassy-china.org.cn/econ/smes2002.html>

guaranteed by China Development Bank. The bond was issued under the NDRC approved enterprise bonds quota approved in early 2007.

As the policy and regulatory environment opens up in favour of SMEs, there is potential for stronger and faster private sector development in China. The SME Promotion Law will help, especially if it means better access to bank lending, as would improvement in, and expansion of, the credit guarantee system.

The emergence of Sovereign Wealth Funds

At the time of writing this report, a new trend which is gaining increasing publicity is the emergence of multiple sovereign wealth funds (SWFs). These government-run investment funds are financed using China's extensive surplus of foreign reserves and are increasingly important players in global markets. China Investment Corporation (CIC) alone, for example, has over US\$ 200 billion dollars to invest and is the sixth largest SWF in the world (Table 2). The CIC plans to spend roughly two-thirds of its US\$ 200 billion assisting Chinese banks, such as for example, the Agricultural Bank of China and the China Development Bank, two state-owned banks preparing for initial public offerings in the near future.²⁴ SWFs are estimated to control more than US\$ 2.5 trillion and it is thought they could control as much as US\$ 12 trillion by 2015.²⁵ SWFs have generally been used for acquiring foreign assets and these large funds are also used to bolster the banking system.

Table 3: World's Ten Largest Sovereign Wealth Funds

Country	Fund Name	Assets (US\$)
UAE	Abu Dhabi Investment Authority Fund	875 bn
Norway	Govt Pension Fund	341 bn
Singapore	Govt of Singapore Investment Fund	330 bn
Saudi Arabia	Saudi Arabian Funds (various)	300 bn
Kuwait	Reserve Fund for Future Generations	250 bn
China	China Investment Corporation	200 bn
Singapore	Temasek Holdings	159.2 bn
Libya	Oil Reserve Fund	50 bn
Algeria	Fond de Regulation des Recettes	42 bn
Qatar	Qatar Investment Authority	40 bn

Source: Morgan Stanley

Although some commentators are wary of the intentions and potentially market-distorting effects of SWFs, some Western banks have recently welcomed this countercyclical investment as 'fiscal stabilisation'²⁶ with infusion of Asian capital recently assisting ailing American and European banks, which are suffering from the recent economic slow-down caused by the sub-prime mortgage crisis and subsequent US economic slowdown. While not an SWF, the Chinese insurance company Ping An tapped into China's substantial foreign exchange reserve to spend US\$3.32 billion (€2.1 bn) to buy 50 percent

²⁴ "Sovereign Wealth World", James Surowiecki, November 26, 2007, The New Yorker

²⁵ "Sovereign Wealth World", James Surowiecki, November 26, 2007, The New Yorker

²⁶ This week, US banking giants Citigroup and Merrill Lynch turned to Middle Eastern and Asian sovereign funds, among other outside investors, for a second time in two months to shore up balance sheets battered by massive write-downs.

A raft of other bastions of Western capitalism, including UBS, Morgan Stanley, Barclays and Bear Stearns have sold off chunks of themselves to sovereign funds since the subprime fallout came home to roost last summer. In all, Wall Street banks have received \$59bn in bailout money.

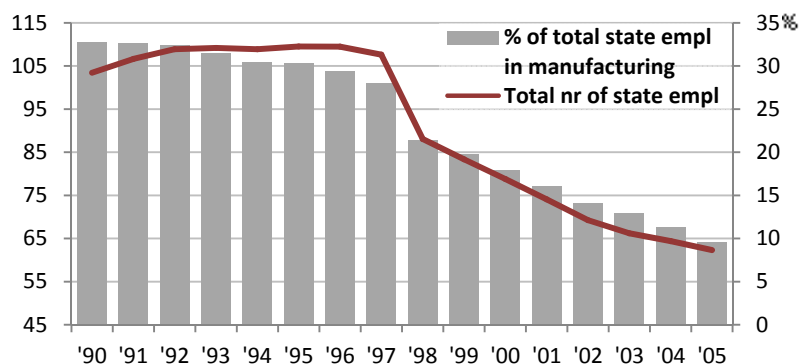
stake in Fortis's asset management subsidiary, gaining access to a business with US\$378 billion (€239.8 bn) of assets under management.

2.2 Social trends

Urban Social Issues Resulting from Financial Reform

The central government has used the banking system to keep afloat money-losing SOEs in urban areas by pressuring state banks to provide low interest loans, without which a large share of the SOEs would likely go bankrupt. Currently, about 70 percent of state-owned bank loans now go to the SOEs, even though a large share of loans are not likely to be repaid, threatening to push back up Chinese banks' NPL ratios. Corruption poses another problem for China's banking system because loans are often made on the basis of political connections. In many cases, bank branches extend loans to firms controlled by local officials, even during periods when the central government has attempted to limit credit, due to inflation concerns. Such a system promotes widespread inefficiency in the economy because savings are generally not allocated on the basis of obtaining the highest possible returns. In addition, inability to control the credit policies of local and provincial banks has made it very difficult for the central government to use monetary policy to fight inflation without causing major disruptions to the economy. For this reason, since the 1990s the state has drastically reduced employment numbers in SOEs by about 41 million. These reforms have been particularly felt in the manufacturing sector (Figure 5).

Figure 5: Reduction in the number of state employees (mn)



Source: China Statistical Yearbook (2005, 2006)

Rural Issues

The effect of China's rapid growth has not been equal, with urban and rural classes affected differently. By liberalising the financial sector, it is not only SOE employees in the urban and middle classes that will be affected by reforms, but the rural population has also been affected by services provided by foreign banks in rural areas. The recent campaign launched by the Chinese government, known as the "Construction of the New Socialist Countryside" in 2005, is aimed at providing services to more than 750 million Chinese peasant farmers. The campaign is intended to revive the rural economy and ease social unrest created by huge wealth disparities between China's booming eastern

cities and far poorer agricultural communities, where the majority of China's population lives.²⁷

Despite the large market for rural financing, given China's large rural population, the low profitability of rural financial institutions has hampered the development of rural finance. Where Chinese banks have been traditionally apprehensive about entering the market for rural financing, more recently rural financing by banking institutions in China, in particular by rural commercial banks and rural cooperative banks, seems to have taken off. Their assets by 2006 were at RMB 4.4 trillion (up 19% over previous year), loans outstanding at 2.6 trillion RMB (up 19%). By end 2006, according to official data by end 2006 70.72 million rural families, which would represent approximately one third of all rural families, had been granted small loans.²⁸ Foreign banks have supported the development of rural finance. HSBC, Europe's largest bank, opened a wholly owned subsidiary in rural Suizhou, in central China's Hubei Province. Other significant foreign lenders including New York-based Citigroup and Asia-focused bank Standard Chartered are preparing to open rural banks as well.

The prospects for further development of rural financing seem promising. Since the radical reform of the rural credit cooperatives in 2003, great strides have been made in the reform of the property rights system and corporate governance. On the whole, the management ability, the risk resistant ability and the service standard of the rural cooperative financial institutions show a remarkable improvement.

In the rural financial sector, CBRC issued a regulation to encourage private investment in 2006. CBRC statistics show that by the end of June 2007, there were 111,302 financial outlets in rural China, accounting for 57 percent of the country's total.²⁹ The government launched a pilot scheme, which was planned in six provinces and autonomous regions including Hubei, Jilin, Sichuan, Qinghai, Gansu and Inner Mongolia, encouraging individuals, private companies and all financial institutions to get involved in rural financing.

While signs of urban and rural sector employment levels appear positive, the picture is not straightforward. Relating to higher levels of employment and corresponding wages, lifestyle patterns in China are also undergoing changes, as a result of trends in urbanisation, mechanisation and industrialisation. Where arable land is eroding, demand for staple foodstuffs is skyrocketing as evidenced by the 31.7 percent increase in the price of meat, poultry and other related products since 2002.³⁰ It is feared that the failure to deal with such inflation could incite political and social tensions. Further, there are signs of labour shortage in the manufacturing sectors due to inadequate human resource with management skills and experience, and fading demographics in the age range of 18-25 year olds, as a result of China's One Child policy.³¹

27 Anderlini, Jamil, 'Foreign Banks Enter Fresh Fields in China', November 16, 2007

28 PBOC (2007) China Financial Stability Report, page 24

29 "Rural Banks lend hope to Country Businesses", www.chinaview.cn, 10 January 2008

30 National Bureau of Statistics of China, 2007

31 Jonathan Anderson, "China: Things Get Ugly", 1 July 2005, Carnegie Endowment for International Peace

The emergence of high net worth individuals and the middle class

In terms of general trends, first, demographic and corresponding changes in China's wealth accumulation patterns suggest that China is experiencing greater concentration of wealth. Today more than 300,000 Chinese have a net worth over US\$1 million.³² In addition, mainland millionaires control some US\$ 530 billion in assets.³³ The number of High Net Worth (HNW) Chinese continues to grow as 2007 data indicates that amongst the countries with the highest increase, China ranks in the top 10 of that category.³⁴

Secondly, a growing middle class with higher disposable income increases the need for more sophisticated financial services. The Chinese Academy of Social Sciences estimates that by 2020 the middle class will comprise 40 per cent of the total population in China.³⁵ Families with assets valued between RMB 150,000 (US\$ 18,137) to RMB 300,000 (US\$ 36,275) are classified as being in the middle class. The number of households with an annual income of more than US\$ 6500 will increase tenfold by 2010, to 30 million.

Thirdly, a distinguishing factor of the Chinese retail banking sector is the typical 40 percent savings rates. In a society characterised by significantly high savings, financial services that are stable and profitable for local investors should provide the necessary incentive for higher spending and consumption. A more diverse and complex range of services and products will also ensure that the needs of the growing middle class is met. Given that European banks have greater expertise in the area of asset management and other related services, they should be able to fill this void, while gaining market access, where they have been previously restricted. The credit card market, for instance, has the potential to serve the Chinese middle class, while profiting by over US\$3 billion in annual revenues by 2010.³⁶ Credit provision and flexible loan schemes will also cater to the increasing need for residential mortgages, which represents 90 per cent of the US\$ 242 billion in outstanding consumer loans. As millions of Chinese become home-owners for the first time in the next 10 years, strong consumer demand should encourage European banks operating in China to develop flexible lending arrangements as most Chinese residents do not have any credit history.³⁷

Other areas of financial services and products that offer lucrative opportunities for both European banks and the Chinese middle class, is that of retail banking, which opened up to foreign banks and credit card monolines in 2007. As China prepares itself for inevitable changes in the social and economic environment as a result of a liberalised banking sector, the provision of complex financial services and products that cater to the current phenomenon of China's new middle class is necessary for the next step of development and growth.

32 Merrill Lynch (2007)

33 BusinessWeek, In China, To Get Rich Is Glorious, 2006, Source http://www.businessweek.com/magazine/content/06_06/b3970072.htm

34 http://money.cnn.com/2007/06/27/pf/world_wealth_report_2007/index.htm

35 Zhigang, Xin, Chinadaily, 2004, Dissecting China's 'middle class,' Source, http://www.chinadaily.com.cn/english/doc/2004-10/27/content_386060.htm

36 The McKinsey Quarterly 2003 Special Edition: Global Directions

37 BusinessWeek, In China, To Get Rich Is Glorious, 2006, Source http://www.businessweek.com/magazine/content/06_06/b3970072.htm

2.3 Environmental Trends

The direct impact of the banking sector on the environment is hard to discern. Despite the increasing focus on sustainable development and environmentally-friendly initiatives globally, banks still lag behind in their responses compared to other industries such as technology and telecoms. This is possibly a result of the limited understanding of the role of finance in the environment. Further, there is also no cohesive response vis-a-vis current environmental issues from the industry as a whole.

Despite the fact that financial institutions have relatively small and direct input on the environment, more sustainable banking practices may help to promote the development of less energy intensive sectors, which work closely with or are dependent on the involvement of the financial industry. There does appear to be stronger commitments to socially and environmentally responsive practices by engaging in specific national and global environment-related projects by financial institutions.

In China, at the start of 2008, China's State Environmental Protection Administration (SEPA) signed an agreement with the IFC to discourage industrial polluters by establishing the globally recognised 'Equator Principles', which are a voluntary set of guidelines for assessing and managing the environmental and social risks with project finance.³⁸ Through joint research, SEPA and IFC will develop environmental standards for lending by Chinese banks, providing a set of international standards for China's 'Green Loan' initiatives, launched in July 2006 by SEPA in partnership with China's Central Bank and the CBRC. These initiatives aim to use financial tools as incentives, while factoring environmental considerations when distributing loans.³⁹

The United Nations Environment Programme (UNEP) Financial Initiative is another example of efforts made by financial institutions to address environmental concerns, such as those highlighted by the 2006 Stern Review. The Review particularly highlights the costs to developing countries, such as China, if adequate measures are not taken immediately to handle the imminent problem of global warming. Further, it is indicated that mitigation efforts in the form of sustainable investments in areas of energy efficiency, renewable energy and an efficient global carbon trading markets, can lead to net benefits of up to \$2.5 trillion.⁴⁰ So far, it is mostly European and American banks that have initiated specific projects in this area, such as the "European Clean Energy Fund" by Swiss Re and Dresdner and European Investment Banks' €600m-1bn "Climate Awareness Bond", both of which are examples of support for clean energy and energy efficient measures and policies.

Relative to European banks, Asian banks have done less in terms of bridging the financial industry and broader environmental policies. Efforts in China, however, suggest that compared to other Asian countries, China is making significant strides to curb pollution and tackle other environmental problems by linking those challenges to project finance. China Merchants Bank after

38 "Analysis: China Uses Green Loans to Tackle Environmental Problems", Yingling Liu, 11 February 2008

39 "China to bring in Green Loan Benchmark", China daily, January 25, 2008

40 UNEP Finance Initiative, CEO Briefing, December 2007

joining the Finance Initiative in October 2007 is amongst the first of the Chinese banks to assess the impacts of environmental and social considerations of financial performance.⁴¹ Its loans for renewable energy have increased by 26% since the start of 2007, and loans for green equipment, water treatment, garbage treatment and air pollution prevention and abatement have also increased by 18%.⁴²

A number of banks have responded to the Carbon Disclosure Project 2007, where membership allows signatories to take a pro-active role in carbon disclosure. More importantly, the project provides a platform for dialogue to create responses to climate change. In the context of the banking sector, such an arrangement is particularly useful as these companies do not have the benefit of government policy guidance or carbon trading markets which would create transparent price incentives for action. Instead, they are responding to a range of pressures - from customers, competitors, investors and global regulators. Such responses, in turn, promise to shape their long-term competitiveness.⁴³

In the area of microcredit, a field with vast potential in a country with a rural population the size of China, there have been cases of EU and China engagement, suggesting potential for further cooperation and involvement of finance in the environment. For example, The Natural Forest Management Programme (June 2003-June 2008) conducted in Beijing, Hainan, Hunan, and Sichuan provinces between the State Forestry Administration and the EU Delegation in China, sought to promote the environmental stability and sustainable development by providing micro-finance to local communities to enabling them to develop economic alternatives to forest utilisation. The effects of such initiatives are also social, with impacts on community development and public education. Rural finance can therefore be an important contribution to diversify economic activity in local communities which currently rely on resource-intensive activities.

Increasingly there is recognition by Chinese policy-makers of the role finance potentially plays in environmental sustainability. In July 2007, China's State Environmental Protection Agency (SEPA), the People's Bank of China (PBOC) and CBRC jointly issued the *Advice on Implementing Environmental Protection Policy and Regulations to Avoid Credit Risks*, indicating that 'Green Credit' has played a role in pollutant and emission reduction as an economic means. The policy has won the support from the environmental protection departments and the financial regulatory institutions of more than 20 provinces, who jointly issued implementing plans and specific regulations on Green Credit.

In addition, China's policy lending bank, the National Development Bank (NDB), has increasingly controlled loans to enterprises with high energy consumption and high pollution. At the time it has set up the "Special Loan for Energy Saving and Emission Reduction", lending great support to eight key environmental aspects (e.g. water pollution treatment projects, sulphur dioxide treatment projects for coal-burning power plants, etc.). These loans for environmental

41 "Analysis: China Uses Green Loans to Tackle Environmental Problems", Yingling Liu, 11 February 2008

42 *Ibid*

43 Carbon Disclosure Project, Asia Report 2007.

protection have increased on average by 35.6% annually since 2000. By 2007, 15 branches of the NDB lent RMB 30 billion (€2.9 bn) to support environmental protection projects. Wherein, Jiangsu Branch, in cooperation with Jiangsu provincial government, invested RMB 4.5 billion alone in Wuxi for the pollution treatment of the Taihu Lake disaster.⁴⁴

2.4 Future Directions

Looking towards future developments, there is sufficient political mandate in China for further financial sector reforms. China's 11th Five-Year Plan 2006-2010 (5YP) states that, 'priority will be given to the transformation of government functions and deepening reforms of enterprises, fiscal and tax systems as well as the financial sector'.⁴⁵ On financial sector reform specifically, the 5YP sets out ambitions to promote better accounting systems and increase the efficiency of capital use with commercial banks encouraged to reduce their bad debts and increase profitability. This complements China's overall growth strategy, as laid out in the 5YP, which emphasises domestic demand, particularly consumption, with a strong focus on rural economic development and expanding social services such as education and health care. The shift of emphasis away from investment towards consumption-driven growth will need to be underpinned by increased access to a more diverse and sophisticated range of financial services. This would facilitate consumption, as a large cross-section of Chinese society, notably an emerging middle class, prepares for first-time ownership of homes and other luxury goods.

Alongside these marketisation initiatives, however, there remains explicit mention in the 5YP of deepening reform by relying on administrative intervention as a way of giving a primary role to the market in allocating resources under guidance of 'macro regulation and control'.⁴⁶ This means that China's financial reforms will continue to be measured, particularly to the extent that the financial sector will be further opened up to the participation of foreign financial institutions in the Chinese market. China will continue pursuing the benefits of foreign investment, while at the same time seeking to limit the competitive impact of foreign financial institutions. Although detailed application procedures to expand their business scope and open new branches exist on paper since 11 December 2006, the degree to which foreign banks enjoy full access to China's banking sector in future depends on how efficiently applications are handled by China's regulators, notably the CBRC. It is expected that vaguely worded regulations and poorly explained application procedures will mean that many foreign banks will continue to have difficulties in expanding in a notionally more open market.

44 See EU-China Trade SIA Global Analysis Report, available at www.euchina-sia.com

45 '11th Five-Year Plan', Special Report. www.gov.cn

46 '11th Five-Year Plan', Special Report. www.gov.cn

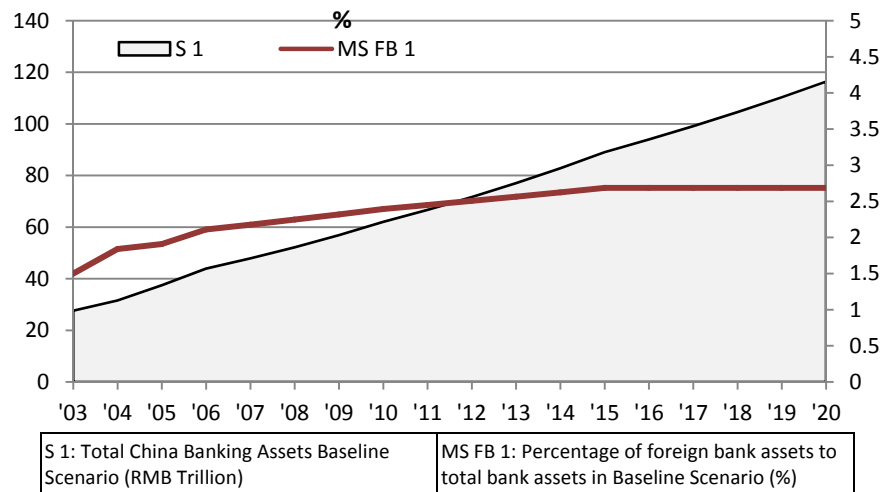
3. PCA Scenarios

The following sections consider the baseline trends and two possible liberalisation scenarios which may result from new market opening commitments resulting from a Partnership and Cooperation Agreement between the EU and China.

Baseline Scenario

In the baseline scenario outlined in **Figure 3** foreign banks are expected to continue to face limitations in the area of RMB loan and deposit businesses, as well as related areas such as the credit card business, where a partnership with local Chinese banks will continue to be necessary.

Figure 6: Financial Services - Baseline Scenario - Growth of Total Banking Assets, Foreign Participation (RMB Trn)



Source: CBRC (2007); EMG Analysis (2008)

In the short-medium term foreign banks will benefit from the post 2006 reforms which are expected to increase their market share (as measured by proportion of foreign bank assets to total assets) to approximately 2.4 percent by 2010, up from 2.11 percent in 2006. However, benefiting from strong growth in China's banking sector will mean that overall foreign assets will increase by almost 50 percent to RMB 1.49 Trn (€ 149 bn) by 2010, up from RMB 927 bn (€ 92.7 bn) in 2006. As foreign banks are not able to compete on an equal footing, in the longer term it is expected that the share of foreign banks will be restricted to niche markets and continue to remain below 3 percent. It is expected that European bank's market share among foreign banks will remain stable at 35 percent.

In the insurance sector, non-life insurance has been largely liberalised compared to banking and life insurance. The remaining restrictions on foreign operators relate to compulsory cover lines. These will continue to block foreign provider entry from the large market for motor vehicle third party insurance. Absent any new restrictions, foreign insurance companies operating in China will be able to set up their branch networks and distribution channels

with insurance agents. Previous studies⁴⁷ estimate that under baseline trends European insurers will gain a market share (estimated premiums earned) in the non-life insurance market of 5 percent by 2010 (or € 1.1 billion), up from their current share of 0.4% (€ 44 million). In life insurance, current market share of European operators is at roughly 0.8%. Due to practical limitations on market access, the share of European insurance companies in the Chinese market is expected to grow to only 8% market share by 2010 although strictly indirectly (i.e. through investments with Chinese companies or in joint-ventures).⁴⁸ In the long-term, as in the banking sector, this market share is expected to level off should baseline conditions remain in place as current market access obstacles remain for foreign investors.

Modest Liberalisation Scenario

It is assumed in this scenario that licensing restrictions for the opening of new branches are liberalised, while ownership restrictions on foreign financial institutions remain, both in the banking and insurance sectors. In practice, however, discrimination against foreign banks will remain, and China notably continues to apply ownership caps on foreign shareholdings in Chinese banks – despite no foreign equity caps being listed in China's GATS schedule. It is assumed that any concessions made to European financial institutions will be made to other foreign institutions as well.

Liberalised Licensing Requirements means that banks would be able to offer new services

If licensing requirements were further relaxed, foreign banks would as a result of increased administrative efficiency, enjoy more straightforward access to the market and reduced cost-structures. This would allow for a more competitive expansion of their branch network than under baseline conditions.

Foreign banks would be able to tap into RMB deposits more easily; but this would be restricted mainly to wealthy individuals in large cities. An important area that foreign banks are expected to focus would be lending to SMEs, leaving China's larger banks to focus predominantly on SOE-lending. European banks are relatively experienced in this complex field, which requires well-developed credit analysis and risk management capability. European financial institutions would be in a good position to tap into this market. However, the physical constraints imposed on opening up competitive branch networks will place a damper on this.

...however foreign banks would not be able to tap into RMB deposits in a substantial way

With foreign ownership caps on Chinese financial institutions remaining in place, foreign banks will have to grow organically, gradually expanding their branch networks. It is estimated that a competitive nationwide network for China is around 25,000 branches, similar to the amount of a typically large Chinese SOCB.⁴⁹ The cost of building a new branch has been estimated at

47 DG Trade (2007) 'Future Opportunities and Challenges in EU-China Trade and Investment Relations' Study 7: Financial Services

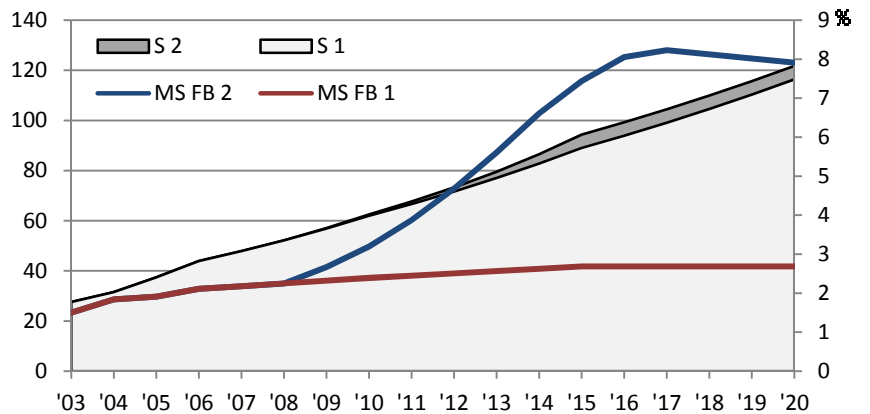
48 *Ibid*

49 DG Trade (2007) 'Future Opportunities and Challenges in EU-China Trade and Investment Relations'

US\$ 400,000.⁵⁰ Even without the currently high capital requirements for registering a new branch, this would tend to physically and financially curb the expansion of foreign banks.⁵¹

If excluded from obtaining controlling stakes in Chinese banks' RMB businesses, foreign banks would face a continued disadvantage and would be unable to tap the RMB deposits and savings of the Chinese population. Not only would this restrict their profit margin, they would be forced to engage in wholesale operations relying on borrowing from other banks. Prudential regulations applied to all banks in China bar any loan-to-deposit ratio exceeding 75%. This will in particular constrain foreign banks, who are dependent on wholesale financing, whereas local banks will be able to rely on deposits. The 75% loan-to-deposit maximum will apply to foreign banks in China from 2011 on and in the longer term will severely constrain the market share of foreign banks.

Figure 7: Financial Services Modest Liberalisation Scenario Growth of Total Banking Assets, Foreign Participation (RMB Trn)



S 1: Total China Banking Assets Baseline Scenario (RMB Trillion)	MS FB 1: % of foreign bank assets to total bank assets in Baseline Scenario
S 2: Total China Banking Assets Modest Liberalisation Scenario (RMB Trillion)	MS FB 2: % of foreign bank assets to total bank assets in Modest Liberalisation Scenario

Given the assumptions of the modest liberalisation scenario, the sector will see a gradual increase of foreign banking sector assets in previously untapped areas. Combined with the increased efficiency of foreign banks this is expected to have a positive impact on total banking assets in China (Figure 4). By 2015 foreign banks could reach a market share of 8 percent.⁵² Although in the long-run total banking assets of foreign banks are expected to increase in line with the overall banking sector this trend will level off once sufficient levels of market saturation occur.

Although total assets growth is expected, in the longer term foreign banks might even lose relative market share to domestic banks. The Banking

50 Bonin & Huang (2002), "Foreign Entry into Chinese Banking" Does WTO Membership threaten Domestic Banks?"

51 To bring this figure into perspective, the US\$ 10 bn required for setting up this number of branches is roughly equivalent to 10% of the total assets of foreign banks in 2007

52 This compares to an average 10.9% share of banking assets which foreign banks have obtained in Korea, Malaysia, Thailand (data from Bankscope)

Strength Indicator (BSI), which measures the financial strength of Chinese banks benchmarked to the fifteen top international banks, already suggests that Chinese banks have strengthened due to increased capitalisation and earnings in 2006.⁵³ Between 2005 and 2006, the index went up by 33.5 percent.⁵⁴ It is expected in both the moderately optimistic and ambitious liberalisation scenarios that with increased competition Chinese banks will increase their capabilities in the long term and are expected to regain market share.

The insurance industry will perform better, but in the long-run will face similar constraints...

For foreign life insurance providers it is unlikely that current ownership restrictions will be reduced under a modest liberalisation scenario. Like foreign banks, foreign insurance providers face challenges in registering branch offices, although to a lesser extent than under a modest liberalisation scenario. Chinese-Foreign life insurers will continue to face difficulties in obtaining licenses to operate in new provinces. Similar to the banking sector this means insurers are effectively prevented from creating national distribution networks under their control and will therefore be unable to operate with the same speed as domestic insurers.

Expected Impacts - Modest Liberalisation

An opening up of the financial sector in a modest liberalisation scenario is expected to have an overall positive impact on the economy. Foreign financial institutions would be a cornerstone of China's institutional framework. International best practices would 'spill-over' from foreign financial institutions who operate on a more efficient allocation of capital. Financial institutions are important when opening up capital markets, and reducing legal and administrative barriers will create long term positive impacts on economic indicators. Notably, this moderate scenario will have only a limited impact on increasing capital formation as limitations on foreign investment results limits the amount of assets which can be accumulated by foreign operators operating locally. Overall social indicators are also likely to improve in the long term under the modest liberalisation scenario, although the picture is more mixed than in the optimistic liberalisation scenario discussed below. In the short term, Chinese banks are likely to have to close down a number of inefficient branches and increase automation to compete with foreign banks. In the longer term, the effect on the wider economy is expected to be more positive as more efficient lending practices will promote sustainable private sector growth, which in turn, will have a positive effect on employment levels. Such impacts, however, may only be discernable in and around large commercial cities where large-scale private sector activities are focused. The impact on the environment is expected to be negligible.

53 The Banking Strength Indicator is based on the CAMELS rating of the Chinese banks relative to top fifteen non-Chinese banks, which are ranked according to their Tier-1 capital. Each CAMELS component is also based on underlining variables, including, but not limited to: capital asset ratio; Tier-1 capital ratio; the ratio of nonperforming loans to gross loans; loan-loss coverage ratio; the cost-to-income ratio; return on assets; return on equity; the ratio of liquid assets to deposits; and the ratio of non-interest-based revenue to total assets. (See <http://www.milkeninstitute.org/chinaindicators>)

54 <http://www.milkeninstitute.org/chinaindicators>

Economic Impacts

Based on scenario assumptions that measure the effects of reductions in non-tariff barriers (NTBs) and changes in Total Factor Productivity (TFP), the main and obvious changes are in the import and export levels of financial services.⁵⁵ In a modest scenario that assumes a 30% reduction in NTBs, there is a 16.46% increase in imports of financial services. The corresponding change in the export levels of Chinese financial services is -0.63%, which may appear negligible, but in a market the size of China's the number is substantial enough to suggest that such a decline in exports due to a cut in the NTBs alone because of the general equilibrium effect, will result in capital and labour moving out of the sector. Where Chinese banks and insurance providers may lose out due to increased access to the Chinese market of European banks and insurance companies, the latter will gain substantially.

Under the modest liberalisation scenario highly localised economic benefits are expected due to improved fund and asset management, where foreign banks have better access to the segment of wealthy individuals who require sophisticated financial services and products within cities. This clientele are willing to pay for better services, reputation and international contracts. By catering services to a niche crowd, the involvement of European banks will improve the quality of financial services in China, however, this only pertains to a narrow stratum of Chinese society, so the economic impact will probably be very concentrated amongst wealthy individuals. This could have a negative impact on income inequality as the widening wealth gap in urban and rural areas is precipitated by unequal access to banking services.

Similarly, due to the growing financing requirements of private enterprises, albeit not as dramatic as in the field of consumer financial services, the demands for corporate client and SME business is expected to increase. This means that the effective credit supply to SOEs is reduced and will help the restructuring of the Chinese economy. Although this will have substantial positive economic impacts by improving bank profitability and reducing the number of NPLs held by banks in China, this will also cause localised shift in employment patterns away from the state-owned sector.

A similar trend is seen in an ambitious PCA liberalisation scenario, where the imports of European financial services will increase to 36.55%, and export levels of Chinese financial services will drop further to -1.23%.

When the issue of TFP is introduced in addition to reduction to NTBs, the positive incentives to export are enough to overcome the transfer of factors out of the sector so that exports increase. Additionally, a small depreciation of the real exchange rate will result from variations in the export and import levels.

55 Modelling for Section 3 of the Financial Services Study was done using Globe. Please refer to the Globe technical appendix for further details.

Social Impacts

As is explicitly recognised in China's 11th Five-Year Plan (5YP), a modern financial system promotes better and more job opportunities, especially as young and qualified locals enter the job market. By liberalising the sector, both basic and complex banking skills are developed, with effects on the short and long term overall structure of the industry, job opportunities and comprehensive competitiveness.⁵⁶ A liberalised banking sector may in the interim displace a large number of workers from state-owned enterprises. For instance, as the volume of loans to SOEs is reduced due to more competitive loan requirements, current trends in SOE layoffs are likely to continue unabated. However, in the long-term, a more competitive financial sector should produce more employment opportunities in the private sector, particularly SMEs.

The Chinese government is aware of the impact that SMEs as job-creators can have on forestalling potential social unrest resulting from unemployment. SMEs can potentially be more important for preserving social stability than the social security system. Local experts have offered an important caveat: many workers laid off from SOEs are in their 40s and 50s who lack the new skills needed to succeed in more competitive private ventures.⁵⁷

Environmental Impacts

It is increasingly recognised that the lending decisions and influence on client behaviour of financial institutions may indirectly affect the environment.⁵⁸ In addition, international financial institutions are increasingly aware of the risks associated with environmental issues and are developing more stringent environmental policies to minimise these risks.⁵⁹

Given that foreign financial institutions are more involved in environmental initiatives than local counterparts, it is assumed that best practices in this area would likely be more widely shared should foreign participation increase. Any such beneficial impact of a modest increase in the participation of foreign banks is likely to be minimal given the still limited, though increasing, recognition the role of financial services in environmental sustainability.

Ambitious Liberalisation Scenario

The ambitious liberalisation scenario considers the same conditions as an agreement in which foreign financial institution would be able to acquire a majority controlling stake in local banks and insurers. Substantial reduction in formal obstacles improvements are also assumed in a number of informal barriers for foreign operators such as the behaviour of the regulator in approving new products and formulation of new rules including in the securities business.

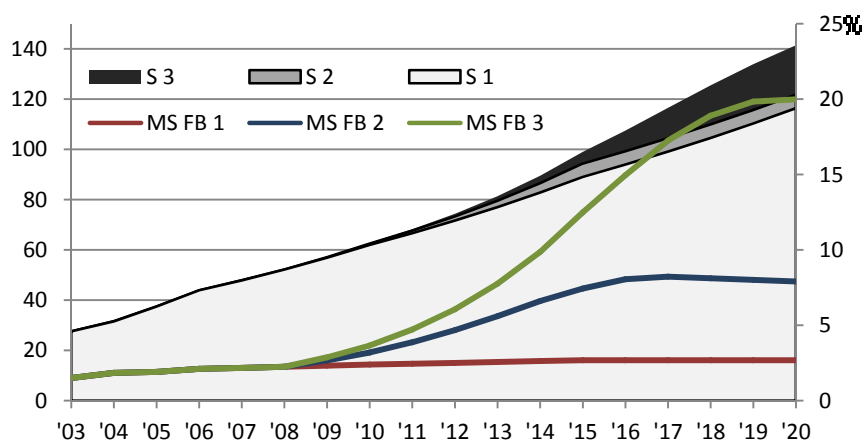
56 China Internet Information Center (2006), Key Points of the 11th Five-Year Guidelines, <http://www.china.org.cn/english/2006/Mar/160397.htm>

57 US Embassy Economic Report, <http://www.usembassy-china.org.cn/econ/smes2002.html>

58 UNEP (1998) Industry and Environment, Vol. 21, No 3, July-September

59 An example of this is The Carbon Disclosure Project, of which a large number of international financial institutions are members. This organisation aims to take a pro-active stance on carbon emissions abatement as a recognition of the risks of inactivity on climate change, while also responds to a range of pressures from customers, competitors, investors and global regulators

Figure 8: Financial Services Ambitious Liberalisation Scenario - Growth of Total Banking Assets, Foreign Participation (RMB Trn)



S 1: Total China Banking Assets Baseline Scenario (RMB Trillion)	MS FB 1: % of foreign bank assets to total bank assets in Baseline Scenario
S 2: Total China Banking Assets Modest Liberalisation Scenario (RMB Trillion)	MS FB 2: % of foreign bank assets to total bank assets in Modest Liberalisation Scenario
S 3: Total China Banking Assets Ambitious Liberalisation Scenario (RMB Trillion)	MS FB 3: % of foreign bank assets to total bank assets in Ambitious Liberalisation Scenario

Figure 5 outlines the impact of an ambitious liberalisation scenario of a PCA agreement between the EU and China on banking sector assets. Increased foreign participation of the banking sector is expected to have a substantial positive impact on growth in total banking assets due to increased investment by foreign banks and their country-wide participation in currently untapped markets, particularly SME loan provisions. This means that under the ambitious liberalisation scenario, total banking assets are expected to reach levels as much as 21.5 percent higher by 2020 than under the baseline scenario (in which no new liberalisation agreements are made). Foreign market share under this scenario is expected to reach 20 percent of total banking assets by 2020.⁶⁰ Given an equal footing, European banks would be well positioned to tap into new and growing market segments. Assuming European banks maintain their market share between 35 and 40 percent of foreign banking assets, they would reach total assets between RMB 9.9 trillion (€990 bn) and RMB 14.1 trillion (€1.40 trn) by 2020. However, local banks benefiting from eventual technology and knowledge spill-over from foreign banks are expected to continue to remain dominant as they improve their capacity to operate effectively leading to their extensive branch network to become a source of competitive advantage rather than the overhead liability.

With regards to insurance, previous estimates of an ambitious liberalisation scenario⁶¹ suggest that European providers could gain a share of up to 10 percent of the non-life market business by 2010, up from the current market share of about 0.4 percent. In absolute terms this would mean a 56-fold

⁶⁰ This is comparable to the 24.2% foreign share of total banking assets in Latin America (Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela). Figures from Bankscope (2008)

⁶¹ DG Trade (2007) 'Future Opportunities and Challenges in EU-China Trade and Investment Relations'

increase in non-life insurance premiums for European operators in China from about €44 million in 2004 to about €2.5 billion in 2010.

European operator's market share of life insurance could rise from approximately €300 million at present to up to €18 billion by 2010, with their market share growing from approximately 0.8 percent to 12 percent.⁶² Like the banking sector it is expected that Chinese life insurance will continue to dominate the market. The three largest Chinese life insurers (China Life Insurance Company, Ping An Life Insurance Company and China Pacific Life Insurance Company) account for 83 percent of premiums, with only Ping An having a foreign investor (HSBC) holding a 19.9 percent ownership stake. These companies will continue to leverage their substantial branch network and local name recognition to their competitive advantage.

Expected Impacts - Ambitious Liberalisation

As argued in the modest liberalisation scenario, the wider Chinese economy will benefit through the reduction of regulations and greater access to financial products and services. In the ambitious scenario, reforms will take place less gradually, which could lead to greater and more rapid benefits being accrued. Such immediate reforms could also provide less of a buffer or adjustment period, leading to challenges, which may only be overcome in the medium-long term.

Table 4: PCA Scenario Impacts Table – Financial Services (China)

Indicator	Existing Conditions	Scenario Impacts		Policy Options	
		Overall Direction Magnitude	Equity	Potential for Reversibility	Capacity to change
Economic					
Real Income	-	↑	⊙	Yes	L
Inflation	--	↑	⊙	Yes	H
Capital Formation	+	↑↑	⊙	Yes	M
Regulatory Environment	-	↑↑	⊙	Yes	H
Products & Services	-	↑↑	⊙	Yes	H
Social					
Employment (Direct)	+	↓	⊙	No	L
Employment (Indirect)	0	↑↑	⊙	No	M
Class Inequality	--	↓↑	⊙	No	M
Poverty	-	↑	⊙	No	M
Environmental					
Pollution (Indirect)	--	□/↑	⊙	Yes	H

Table 5: PCA Scenario Impacts Table – Financial Services (EU)

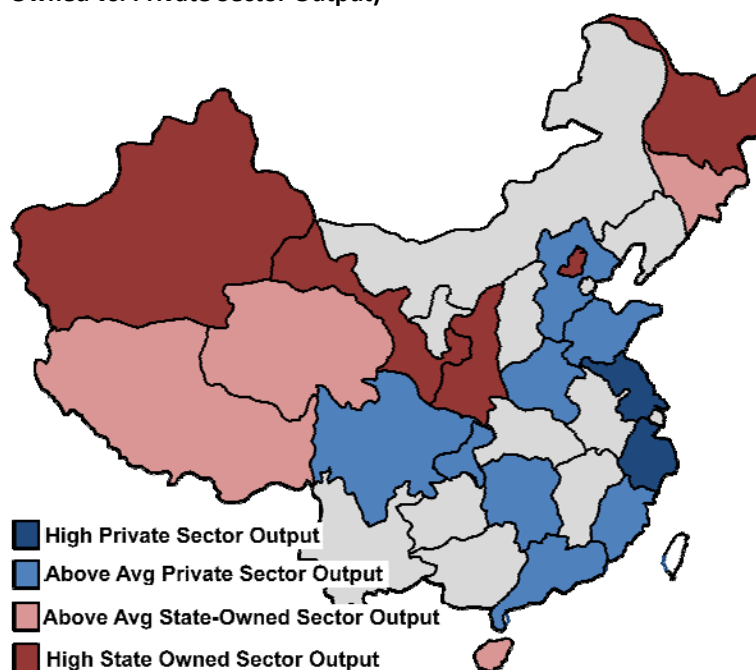
Indicator	Existing Conditions	Scenario Impacts		Policy Options	
		Overall Direction Magnitude	Equity	Potential for Reversibility	Capacity to change
Economic					
Service Exports	-	↑↑	⊕	Y	L
Market Access	--	↑↑	⊙	Y	L

⁶² Ibid

Economic Impacts

The economic benefits of financial reforms tend to accrue in the long run; and costs tend to accrue in the short-term. Substantial lay-offs can be expected in the short run as finance under a more liberal and competitive environment is redirected from the state sector towards the private sector. **Figure 6** highlights the provinces where SOEs still play an important role in the economy. With more stringent loan-processing methods, less productive SOEs would either have to improve their operational standards, change capital management structure or shut down. Provinces marked in red would therefore be relatively highly affected by ambitious financial sector reforms.

Figure 9: Provincial Distribution of Gross Industrial Output Value (State-Owned vs. Private Sector Output)



Source: China Statistical Yearbook (2006)

In the long term, however, strong economic and employment benefits are likely to be felt across China. Previous studies have argued that financial reforms that direct more funds to private companies could raise GDP by as much as 17 percent, or US\$320 billion a year, stimulate mass job creation in the strongest areas of China's economy, and raise tax revenues to finance social programs.⁶³ China's productivity would rise sharply if a larger share of funding went to SMEs and other private enterprises, as a result of increased access to loans through competitive means from foreign banks.⁶⁴

The credit policies of local and provincial banks currently makes it very difficult for the central government to use monetary policy to fight inflation without causing major disruptions to the economy. Wider economic benefits are likely to be felt from the substantially improved ability for policy makers to control. Deeper, more liquid, broad-based and transparent markets with greater

63 How Financial System Reform could Benefit China', McKinsey Quarterly, 2006 Special Edition

64 Ibid

participation of sophisticated institutional investors markets, which are more representative and reflective of strong underlying economic fundamentals, means China will benefit from less volatility, better dispersion of risk and greater stability.⁶⁵ The wider availability of products and services tailored to the needs of customers will also have important welfare effects, not only for businesses, but also for consumers in both urban and rural areas. In addition, substantial beneficial spill-over effects accrue as areas such as trade finance continue to grow further underpinning China's increasing importance as exporter and importer on international markets.

Social Impacts

Over the past decade, Chinese households have earned only 0.5 percent a year on their real savings compared to 1.8 percent for households in South Korea.⁶⁶ Given demographic changes in China, where there is a growing middle class and wealth accumulation amongst the wealthiest Chinese, varied asset management and investment products and services would not only utilise household savings more efficiently and facilitate better long-term investments, but also promote more consumption, boosting social welfare and economic growth.

In an ambitious scenario, a liberalised insurance sector would allow foreign insurance companies with expertise in providing both life and non-life insurance in their home markets, to access the growing Chinese markets. Such changes would have strong implications for social security in China, previously such services were provided by SOEs, but in this ambitious scenario, market competition will have a positive effect on the development of China's social security policies. As China transitions to a liberalised economy, a more forward-looking social security system created as a result of greater market competition is more befitting and holds more prospects for the welfare of Chinese households.

Environmental Impacts

As analysed above, currently the majority of loans go to SOEs and often in energy intensive industries. By boosting consumption, a liberalised financial industry will help to develop a number of alternative industries in the private sector, notably less energy intensive services industries. Such changes will have a positive impact on the environment, while simultaneously diversifying China's economy. In addition, if current trends in the international banking sector continue, the increased participation of foreign banks might aid to instil a so-called 'race to the top', where best-practices in socially and environmentally responsible lending is integrated into core business models.

In the insurance sector, China's Insurance Regulatory Commission (CIRC) recently issued the *Guidelines on Environmental Pollution Insurance* which defined the establishment of a roadmap for an environmental pollution insurance system in China by 2015.⁶⁷ Foreign insurance providers, familiar with

65 DG Trade (2007) 'Future Opportunities and Challenges in EU-China Trade and Investment Relations'

66 How Financial System Reform could Benefit China', McKinsey Quarterly, 2006 Special Edition

67 China ushers in "green insurance system" to curb pollution," *Gov.cn*, 18 February 2008. Available at: http://english.gov.cn/2008-02/18/content_892569.htm.

similar systems in other countries and specialist knowledge on risk assessment, loss evaluation, responsibility claim, dealing with accident and compensation etc, would be able to contribute to the establishment and commercial viability of such a system.

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Annex 1: Scenario Assumptions

S1: Baseline Scenario

S2: Modest Liberalisation Scenario

S3: Ambitious Liberalisation Scenario

	S 1	S 2	S 3
Key Liberalisation Assumptions	<ul style="list-style-type: none"> - Post-2006 WTO commitments are maintained - Improvements for conditions of foreign banks mainly the result of the further maturing of the Chinese financial system. - Ceiling on foreign ownership stake in Chinese financial institutions remains in place preventing controlling stake. (Apart from non-life insurance companies) - The existing regulation, that no bank in China can have a loan-to deposit ratio of more than 75% (which puts banks financed by deposits in advantage towards banks financed wholesale) 	<ul style="list-style-type: none"> - Branch licensing requirement streamlined making it easier for foreign banks organically. - Ceiling on foreign ownership stake in Chinese financial institutions remains in place preventing controlling stake (apart from non-life insurance companies). - no bank in China can have a loan-to deposit ratio of more than 75% (which puts banks financed by deposits in advantage towards banks financed wholesale) 	<ul style="list-style-type: none"> - Branch licensing requirement liberalised making it easier for foreign banks organically. - Foreign financial institutions are permitted to hold controlling stake in Chinese financial institutions. - Existing regulation is removed so that no bank in China can have a loan-to deposit ratio of more than 75%; this levels the playing field between banks mainly financed by deposits, and banks mainly financed wholesale
Compound Annual Growth Rate (CAGR) of Total Banking Assets 2008-2015	7.9	8.8	9.6
Compound Annual Growth Rate (CAGR) of Total Banking Assets 2015-2020	6.9	6.6	9.3
Foreign banking assets as a proportion of total 2020	2.7	7.9	19.99
EU proportion of foreign banking assets	35%	35%	35% , 40% (post-2015)
EUR-CNY Exchange rate (2006) Avg ⁽¹⁾	1.0250	1.0250	1.0250

⁽¹⁾ Figures are nominal with fixed currency exchange rate