FOREIGN BANKS IN CHINA:

CRITICAL SUCCESS FACTORS AND LESSONS LEARNT

ARATI VARMA
SUSANN NAOMI ISRAEL
MASAYOSHI ODAKA
GABRIEL RÜECK

NANYANG BUSINESS SCHOOL
NANYANG TECHNOLOGICAL UNIVERSITY

2003

FOREIGN BANKS IN CHINA

CRITICAL SUCCESS FACTORS AND LESSONS LEARNT

Submitted by:

ARATI VARMA
SUSANN NAOMI ISRAEL
MASAYOSHI ODAKA
GABRIEL RÜECK

Supervisor:

ASSOCIATE PROFESSOR RAMIN COOPER MAYSAMI

MBA DISSERTATION

Submitted in partial fulfilment of the requirements for
the degree of Master of Business Administration
in the Nanyang Business School
Nanyang Technological University

2003

DECLARATION

We declare that this dissertation is based on a project jointly undertaken by us and that our individual effort and contributions to the dissertation can be reasonably identified as follows:

1. Susann Naomi Israel **Registration No: G0200064C**

Contribution:

I was the co-ordinator of the group, during both the project's kick-off phase and the writing of the first draft versions of the dissertation, perhaps due to my proximity with our partnering financial institution Deutsche Bank AG in Singapore and Shanghai. I took charge of conducting initial interviews in Singapore, writing an outline of the dissertation, a number of chapters and the in-depth research and evaluation of Financial Journals, Singaporean bank regulations and interview results. We jointly discussed the results and co-wrote each section of the report.

It is difficult to apportion the efforts made by each collaborator to the report. We were all involved in every phase on this dissertation. Our efforts were synergistic and our contribution to the dissertation should be treated as equal.

Finally, we are most grateful to our supervisor Associate Professor Ramin Cooper Maysami for his timely advice and guidance.

Signature of participant:

2. Gabriel Rüeck **Registration No: G0200001B**

Contribution:

I co-ordinated the onsite visits in Shanghai and organised additional interviews with foreign financial institutions there. I took charge of writing the initial draft of a number of chapters of the dissertation and the respective in-depth research of Financial Journals, Chinese bank regulations and interview outcomes. I was also handling the editorial for the finalisation of the project. We jointly discussed the results and co-wrote each section of the report.

It is difficult to apportion the efforts made by each collaborator to the report. We were all involved in every phase on this dissertation. Our efforts were synergistic and our contribution to the dissertation should be treated as equal.

Finally, we are most grateful to our supervisor Associate Professor Ramin Cooper Maysami for his timely advice and guidance.

Signature of participant:

3. Arati Varma **Registration No: G0201422F**

I took charge of initial sourcing of data and conducted in-depth research on the Banking industry and Regulatory framework in China. I initiated and participated in interviews with key personnel at the foreign financial institutions. I not only wrote the initial drafts of a number of chapters, but also monitored and amended what I thought were "loose ends" throughout the dissertation project. This was accomplished by conducting a thorough review of the dissertation paper, with special regard to consistency and relevance and depth of information, which helped steer the project to its successful completion.

It is difficult to apportion the efforts made by each collaborator to the report. We were all involved in every phase on this dissertation. Our efforts were synergistic and our contribution to the dissertation should be treated as equal.

We are most grateful to our supervisor Associate Professor Ramin Cooper Maysami for his timely advice and guidance.

Signature of participant:

4. Masayoshi Odaka **Registration No: G0200098G**

Contribution:

I contributed to the initial draft of the dissertation by collecting material and reviewing literature about China and the current business environment in Shanghai. I further conducted the review of the initial draft chapters with regard to sufficient consistency and depth. We jointly discussed the results and co-wrote each section of the report.

It is difficult to apportion our contributions to the report. We were all involved in every phase of this dissertation. Our efforts should be treated as equal.

We are grateful to Associate Professor Ramin Cooper Maysami, without whom this report may not be completed in time.

Signature of participant:

ACKNOWLEDGEMENTS

We are deeply grateful to many persons who have contributed to the production of this dissertation. We certainly would not have been able to provide this document in its current form without the valuable information and patient help of our interlocutors in the various banks. Among our benefactors were Mr. Frank Hamer, General Manager of Deutsche Bank AG Shanghai Branch; Dr. Hans J. Schniewind, General Manager of Dresdner Bank AG Shanghai Branch; Dr. Zhou Kunping, Deputy Manager of the Bank of Communications, Research and Development Department; Mr. Pan Honggang of the Bank of Communications in Shanghai; Mr. Peter Ang, Vice President of Bank of America in Singapore; Mr. Shawn Xue, Head of Treasury of Bank of America N. A. Shanghai Branch; Mr. Choy Mun Loong, Senior Manager of DBS Shanghai Branch, Credit Management Corporate Banking; Mr. Sam Yang, Account Manager of DBS Shanghai Branch, Corporate Banking; Mr. Chi Ho Ng of DBS Shanghai Branch; Mrs. Bina Padhye, Compliance and Legal Department of Bank of America in Singapore; Mr. Holger Morneweg of the gic Delegation of German Industry & Commerce Shanghai; and Mr. Bernd Reitmeyer, Deputy Chief Representative of the gic Delegation of German Industry & Commerce Shanghai.

We also wish to thank very much Dr. Ramin Cooper Maysami who has guided and motivated us in the whole course of the BSM dissertation and who has given us valuable inputs for our BSM. Finally, we also want to thank Dr. John Joseph Williams for his meticulous effort in reviewing our dissertation. Together with Dr. Chen Shaoxiang, he has spent countless hours in preparing the BSM trip to Shanghai, contacting the speakers and organizing the seminars for the benefit of all BSM teams.

SI, AV, MO, GR

TABLE OF CONTENTS

Declaration i

Acknowledgements i

Table of Contents ii

CHAPTER 1 INTRODUCTION 1

1.1 Overview of the Case Study 1

1.2 Context, Objectives, Importance and Application to Foreign Banks 1

1.3 Scope and Limitations of the Case Study 3

CHAPTER 2 BUSINESS IN CHINA 5

2.1 The Chinese Banking Sector 5

2.2 Current Local Chinese Banks 6

2.3 Business Environment, "Guanxi" and Challenges 7

2.4 The Impact of WTO Entry 9

2.5 Current Banking and Regulatory Framework 10

CHAPTER 3 FOREIGN BANKS' OPERATIONS IN CHINA 15

3.1 Market Entry Strategies and Customers 15

3.2 Risks 16

3.3 Opportunities 17

3.4 Overall Presence of Foreign Banks in China 18

CHAPTER 4 FOREIGN BANKS IN SHANGHAI 19

4.1 Role of Shanghai as a Financial Services Centre 19

4.2 Deutsche Bank AG Asia Pacific and Shanghai Branch 21

4.3 Bank of America Shanghai Branch 23

4.4 The Development Bank of Singapore Ltd. Shanghai Branch 25

4.5 Dresdner Bank Group Shanghai Branch 27

4.6 Bank of Communications Head Office Shanghai 28

CHAPTER 5 FINANCIAL SERVICES IN SINGAPORE: A COMPARISON 31

5.1 Role of Singapore as a Financial Services Centre 31

5.2 Challenges for Singapore as a Financial Services Centre 32

5.3 Singapore Banking and Regulatory Environment 33

5.4 Business Categories and Further Regulations 36

5.5 Future Growth Prospects 38

5.6 Local Competition and Co-operation within the industry 40

5.7 Conclusion 42

CHAPTER 6 RECOMMENDATIONS AND CONCLUSION 45

References 49

CHAPTER 1

INTRODUCTION

1.1 Overview of the Case Study

The case study has been developed in co-operation with foreign banks having a significant presence in China. It comprises an in-depth study of the Chinese business environment for foreign financial services institutions. It seeks to assess the economic, competitive, regulatory and environmental parameters and compares it to the environment in Singapore, which has already emerged as an established business centre in Asia Pacific. More specifically, the authors investigate the level of business sophistication in each of these two countries and summarise their research on the current extent of business involvement and operations of foreign banks. Furthermore, the case focuses on the specific demands, challenges and opportunities of foreign financial institutions (FFIs) especially in Shanghai. Analysing the recent trends and opportunities, the case study focuses on Shanghai's importance as a prospective international finance centre. It concludes with recommendations for foreign banks and an outlook for future prospects of Shanghai's financial services environment.

1.2 Context, Objectives, Importance and Application to Foreign Banks

China's struggle to join the World Trade Organisation (WTO) over the past 15 years ended in December 2001 when it signed the accord for admittance to the WTO. Consequently, the financial services market is expected to increasingly open up to foreign competition, which in turn will help China to support its banking industry. The People's Bank of China (PBOC), China's central bank, has unveiled plans to open the banking sector in various cities and provinces. Geographically restricted

licenses for distinct product areas are already granted to a small number of foreign banks. Two years after the WTO accession, foreign banks will be allowed to conduct unrestricted business in the local currency with Chinese corporate clients. The business with Chinese individuals will be permitted five years after the WTO entry. Foreign banks will then be allowed to offer their services to both corporate and individual customers anywhere in the country.

For key players in global financial services, China's enormous population of 1.3 billion people and the rapidly growing industry sector represent a huge market potential for private and corporate financial services. In fact, China could turn into the main growth area for banks in the Asia Pacific region. China's immense growth supports Shanghai in evolving as a new financial services centre of the region. However, the opportunity to enter China's closely guarded financial sector is not just a promising prospect, but also a challenge.

The quality and range of foreign banks' services in China will compete with the services local institutions can provide to serve the increasingly higher demands of the corporate landscape. However, China's big four state owned banks (SOB) – Bank of China, International and Commercial Bank of China, Agricultural Bank of China and China Construction Bank – have reportedly taken steps for comprehensive reforms and for increasing their international competitiveness. Private financial institutions in China have already been successful in increasing their profitability quite significantly.

The onus now lies on foreign banks to prepare for the future with similar effort and attention to the needs of the local market. Foreign banks must aim to boost their market share of total assets from the current meagre 2% and expand into new products and services and customer segments, by keeping the business risk low. A proper evaluation of the current scenario, in addition to an accurate assessment of

possible business opportunities and a thorough understanding of the Chinese customers, would contribute to the success of a new entrant to China. Formulating the right market entry strategy, coupled with flexibility in conducting business would help in achieving an effective mix of competition and co-operation with the Chinese banks for the years ahead.

In contrast to China, Singapore's development as an international financial centre began in the late 1960s and has proven to be successful in turning the country into a major financial centre in Asia Pacific. Over the years, Singapore's positive economic and financial fundamentals, sound regulatory and business environment, strategic location and well developed telecommunications and infrastructure have attracted many reputable international financial institutions to set up operations in Singapore. The Monetary Authority of Singapore (MAS) is continuously in the process of adapting its supervisory framework in order to cope with the growing complexity of banks' activities and organisational structures.

Foreign banks constantly discuss the opportunities and challenges of China's financial sector. The future role of Shanghai, growth of foreign banks and the role of their branches and will critically depend on the framework and limitations of the Chinese regulatory environment. For a better understanding of the current business environment in China, the case study compares opportunities and shortcomings of these two market environments.

1.3 Scope and Limitations of the Case Study

The following case study covers the business and regulatory environment in Shanghai, China for foreign banks. It provides an overview of the impact of the WTO entry for the finance sector, the regulatory obstacles when entering China, the character and cultural environment of China's financial services market, the local

competitors, the future growth areas, and the present market environment in Shanghai. The authors primarily focus on the business with corporate customers (debt markets, mergers and acquisition, IPO's, cash management, trade services, corporate reorganization, asset management, etc.).

Singapore is undertaking steps to strengthen its position as an international finance centre in the Asia Pacific. For the purpose of providing a forum for discussion, the challenges and opportunities of Singapore's market environment are investigated and contrasted.

The case draws on the experiences of foreign banks' operations in Singapore and Shanghai. In support of the final conclusion, the findings have been discussed with experts in Singapore and Shanghai.

CHAPTER 2

BUSINESS IN CHINA

2.1 The Chinese Banking Sector

Local banks and financial institutions in China fall into five main categories: State banks, policy banks, share ownership commercial banks, urban co-operative banks and international trust and investment corporations. In a share-ownership bank various levels of government, Chinese institutions, and in rare cases individuals, hold shares. Examples are the Bank of Communications, the Shenzhen Development Bank, the China International Trust and Investment Corp. (CITIC) Industrial Bank, China Everbright Bank, Hua Xia Bank, China Investment Bank, China Merchant's Bank, Guangdong Development Bank, Fujian Xingye Bank, The Shanghai Pudong Development Bank, Hainan Development Bank, and China Minsheng Bank (Chen, 1999).

The People's Bank of China (PBOC) has been China's central bank and the banking regulator since 1984. Three major, specialized banks existed under PBOC: the Agricultural Bank of China (ABC), serving the agricultural sector; the China Construction Bank (CCB), specializing in infrastructure finance; and the Bank of China (BOC), which acted as China's foreign exchange bank.

In 1994, China formed three policy banks, the State Development Bank, the Import Export Bank and the Agricultural Development Bank. These banks took over the policy lending functions from the state banks so that they could focus on commercial business. Policy lending means that these banks are used by the Chinese government to fund policy projects, and as instruments for macro-economic control.

The bank restructuring process also led to the development of a new type of bank — the share ownership commercial banks, such as the Bank of Communications, the China International Trust & Investment Corporation (CITIC), the Shenzhen Development Bank, the Shanghai Pudong Development Bank, and so on. Another new type of financial institution that was established during the commercialization process was the urban cooperative bank, which evolved out of 5,000-plus of China's urban credit cooperatives through financial restructuring.

Earlier in 1979, China had also created the international trust and investment corporations (ITICs), the total number of which has grown rapidly to 240 in recent years. Their major function is to raise foreign capital for local governments, with business ranging from direct investments to loans and financial derivatives.

Stock markets in China today have developed organically along with the economic transformation of the economy. China has a nationwide computerized trading system called STAQ, the Securities Trading Automated Quotations system, which is modelled on the U.S. NASDAQ system. National regulatory authority over the securities industry currently comes from the China Securities Regulatory Commission under the State Council. Authorization comes from China's *Securities Law* that took effect in mid-1999. From a base of almost zero in 1990, China's total stock market capitalization swelled to over US$600 billion by mid-2001, with over 1,000 listed companies making China's stock market capitalization second in Asia after Japan and in the top ten of the world. China's stock markets are expected to grow many times over. The outlook for Shanghai appears the most positive.

2.2 Current Local Chinese Banks

The current Chinese banking sector is divided into four large banks, commonly referred to as the "Big 4" and many smaller banks. The Big 4 account for 90% of all

assets and 70% of all lending in the system. TABLE 2–1 compares the assets of the "Big 4" to the assets of the smaller banks.

TABLE 2–1
China's top ten Banks

Rank	Bank Name	Assets in US$mn	ROA (%)
1	Industrial and Commercial Bank of China	521,085	0.1
2	Bank of China Group	405,664	0.2
3	China Construction Bank	333,662	0.2
4	Agricultural Bank of China	262,281	0.0
5	Bank of Communications	85,469	1.0
6	CITIC Industrial Bank	36,215	0.5
7	China Everbright Bank	32,028	0.1
8	China Merchants Bank	31,162	0.5
9	Guangdong Development Bank	23,073	0.1
10	Shanghai Pudong Development Bank	20,960	0.6

The Big 4 are wholly state-owned and subject to policy lending (*Asiamoney*, 2000). They are suffering from a high level of non-performing loans (NPLs), which is suspected to be up to 50% of all loans and thus sums up to five trillion RMB (*The Economist*, 2002), despite the transfer of US$170 billion to four Asset Management Companies (AMC) in 2000: Huaron, Greatwall, Orient and Xinda. The local banks also lack efficient management methods and modern IT infrastructure. However, they have access to the majority of the Chinese savings accounts and therefore also to a cheap RMB supply. Chinese banks are hence an important supplier of RMB currency in the interbank market.

2.3 Business Environment, "Guanxi" and Challenges

Extensive literature exists on the intercultural aspects and the manner of conducting business in China and can be readily found in bookshops. However, there are two

important aspects that should not be underestimated: *guanxi* and the challenges of operating a business in a country in transformation and with a legal system that is not as comprehensive as in developed countries and that is not enforced continuously.

Guanxi literally means "interpersonal relationship" (Yadong, 2000) and "connections". *Guanxi* encompasses more than the usual business connections and is distinguishable from the relationships that enterprises in the West observe. In China, it is important to establish good relationships with the local government, the public and other enterprises before setting up business operations in a certain city. Establishing good relationships must not be confounded with bribery, which, like in other countries, is a criminal offence. It simply means that one should engage in talks and negotiations for the mutual benefit of all stakeholders. Relationships must be cultivated, once they are established, which essentially require personal visits and ongoing contacts. Such contacts can prove very useful in the event of obstacles in one's business or in the set-up of one's enterprise. Unlike in Western countries, where businessmen usually expect everything to work according to defined rules, China is a country in transition, where rules change constantly and sometimes are not or cannot be enforced everywhere. In such an environment, *Guanxi* helps to advance one's business, provided that one has established the right contacts.

Businessmen must also be aware that, in contrast to developed countries such as the U.S or Singapore, the rule of law in China is neither completely established nor entirely enforced. Juridical contentions may take years to settle, even in obvious cases (Chan, 2002). Therefore, business transactions must be planned and executed with more caution than required in developed countries. As an example, some Western enterprises deliver their products only if the payment is held in an account in trust, which is subsequently released on delivery of the product (Klein, 2002).

New foreign businesses in China must also be prepared to be entangled in legal contentions on account of certain business practices that are new to China (*China Online News*, 2003).

Human resources management is another challenging field for foreign enterprises. Chinese employees are very eager to get training and acquire knowledge and are looking for opportunities to do so, especially with foreign enterprises. However, they are also sensitive to the emoluments and expect foreign enterprises to pay higher salaries than local counterparts. Therefore, a foreign enterprise constantly has to monitor its salaries to remain competitive in comparison with other multinational organisations.

2.4 The Impact of WTO Entry

China's accession into the WTO brings abundant opportunities to achieve greater market share, introduce a wider range of products and services, increase equity participation and streamline corporate structures, and gain control over distribution and after-sales services. By 2005, market access and most tariff reductions will have been fully phased-in for several key sectors. China's gross domestic product (GDP) is expected to double by 2010, with average annual GDP growth expected at about 7.2%. The World Bank estimates that China's share of world trade will triple in the next 20 years, bringing it close to 10%. China's entry to the WTO changes the whole banking landscape of the country.

Today, over 200 foreign banks in China have only about 2% of the total banking assets in the country and a tiny fraction of the renminbi (RMB) lending. As a result of the WTO market opening, foreign banks are expected to reap huge benefits, first in corporate banking and trade finance and in the hard currency retail market, and later in general retail banking starting in the coastal cities. Between 10% to 20% of

all renminbi deposits are expected to flow from local banks to foreign banks. Foreign banks not only have an overwhelming advantage in international investment banking but also have access to ample low-cost foreign currencies.

The Chinese central bank welcomes overseas institutions in the market, but there is concern that competition might be too stiff for domestic banks pampered by years of virtual government guarantees. Increased foreign competition will force Chinese State banks to quicken their pace of reform and commercialization. WTO accession offers this orderly platform for the much-needed reform to be introduced to the tightly regulated domestic banking scene. As a result, there will be a gradual transfer of best practices and management skills from abroad to the banks in China. Foreign banks will be allowed to contribute to this process by offering new banking products and services in line with the WTO protocol. Domestic banks therefore need to take full advantage of the two to five years' head start on foreign banks to diversify their business operations and strengthen their customer loyalty. After five years, the phased relaxation should lead to a competitive marketplace, which will not only benefit the financial service providers, but also their retail and corporate customers.

2.5 Current Banking and Regulatory Framework

After the founding of the PRC in October 1949, the PBOC assumed all of the existing Chinese and foreign banks' functions. PBOC served as a central bank and government treasury. It directed and supervised all specialized subsidiary banks, non-bank financial institutions, and insurance companies.

Banks have been key targets for reform in post-1979 China. Among the government's more aggressive reforms have been the modernization of state-owned banks and the creation of new ownership structures. The government aims to move China's banks toward world standards of commercial organization, service, and

competitiveness by strengthening the supervisory and regulatory environment and implementing sound banking practices. Strategies adopted include improving central bank independence, reducing the burden of past non-performing loans, adopting a new loan classification system to help bring China's loans up to international standards and relaxing control over interest rates to encourage lending to small- and medium-sized companies. Further opening of China's banking sector to foreign banks, in response to WTO accession requirements, indicates government efforts to open up the financial services industry, thereby exposing Chinese banks to foreign practices and competition.

To facilitate the growth of foreign trade and direct investment, China initially allowed foreign banks to set up representative offices to engage in liaison service. Since 1985 however, foreign banks have been permitted to engage in foreign currency business as branches in special economic zones and selected cities. The opening of China's financial markets, which adheres to the principle of gradualism and prudent management, has progressively expanded to open coastal cities and inland cities. The current regulations allow FFIs to establish not only representative offices and branches, but also joint venture banks and finance companies, wholly foreign-funded bank subsidiaries, and joint venture investment banks.

The regulatory framework experienced a major change with China's WTO entry, and new regulations were issued shortly before the WTO entry and in the current year. Changes in the regulations are still ongoing, and the information management poses a difficulty to the foreign banks since the laws first have to be translated internally within the organization from Chinese to English and distributed to the affected business divisions. A bank that intends to do business in China has to start by establishing a representative office (Tan, 2003; Isinolaw, 2003). A representative

office is only allowed to engage in non-operating activities such as consulting, liaison and market research (The People's Bank of China, 2002). In order to establish a representative office, the FFI has to submit a formal application at the local branch of the PBOC together with the required documents, i.e. banking license, annual reports and the business plan (The People's Bank of China, 2002).

After having operated a representative office for at least two years, the FFI can apply for a branch with foreign currency license. Branch offices are allowed to conduct profit-oriented banking business with certain restrictions. Depending on whether the FFI intends to set up a branch of a foreign bank or a joint venture (JV) finance company or a joint venture bank, different minimum capital requirements apply. For branches, the FFI has to possess net assets of at least US$20 billion at the end of the year prior to filing the application. Whereas for JV companies or JV banks, as well as subsidiaries of foreign banks or Chinese-Foreign joint banks in China, the minimum net asset requirement is US$10 billion (Isinolaw, 2003; Trade and Industry Department and Trade Development Council, 2003). The application for a banking licence must be accompanied by a feasibility study that proves comprehensive research on the Chinese market (The People's Bank of China, 2003). With a banking licence, foreign banks can engage in foreign currency business all over China and with both Chinese and foreign customers (Câmara de Comércio e Indústria Luso-Chinesa – Delegação de Macau, 2003). Foreign currency deposits received in China by an FFI may not exceed 70% of its total domestic foreign currency assets (China Law & Practice, 2002). Business transactions in RMB still require a special licence issued by the PBOC and can only be granted to banks that have maintained operations in China for at least three years and that have been profitable for at least two consecutive years (The People's Bank of China, 2003). Further, RMB operations

are restricted in terms of the geographical area and the type of customer and will be liberalized during the transition period 2002-2006. Limitations on market access also include restrictions on provision and transfer of financial information, financial data processing and related software by suppliers of other financial services. Advisory, intermediation and other auxiliary services, such as advice on acquisitions and corporate restructuring, investment and portfolio advice and so on, remain restricted for all specified activities. For financial leasing services, however, foreign financial leasing corporations will be permitted to provide financial leasing services at the same time as domestic corporations. Details are given in TABLE 2–2 and TABLE 2–3.

TABLE 2–2
Cities allowed to conduct RMB Operations

Year	Newly Opened Cities for RMB Operations
2002	Shanghai, Shenzhen, Dalian, Tianjin
2003	Guangzhou, Zhuhai, Qingdao, Nanjing, Wuhan
2004	Jinan, Fuzhou, Chengdu, Chongqing
2005	Kunming, Beijing, Xiamen
2006	Shantou, Ningbo, Shenyang, Xi’an
2007	Whole China

TABLE 2–3
Permitted Customers for RMB Operations

Year	Newly Admitted Nationalities for RMB Operations
2002	All Foreigners (Enterprises & Individuals)
2004	Chinese Enterprises
2007	All Chinese (Enterprises & Individuals)

The China Securities Regulatory Commission (CSRC) recently issued a joint statement with the PBOC, promulgating the rules for the Qualified Foreign Institutional Investors (QFII) scheme which is to take effect from 1 December 2002

(Ng, 2002). Accordingly, QFIIs will be allowed to invest in RMB denominated Equity A-shares, Treasury Bonds, Corporate Bonds and Convertible Bonds listed on the stock exchanges. Currently, the regulators are in the process of laying out the detailed implementation procedures, such as account opening and application procedures, documentation requirements, settlement and clearing arrangements and so on. Therefore there is no definitive timeframe for the implementation of the scheme. Foreign banks like Citibank, HSBC, Standard Chartered and local giants Bank of China, Industrial and Commercial Bank of China and Bank of Communications, have all signed up for custodian bank licenses (Jorolan, 2002). Under the existing rules, FFIs can only apply for a QFII license through a designated custodian bank. To date, seventeen professional organisations/regulators, including Monetary Authority of Singapore (MAS) have signed the Memorandum of Understanding with CSRC.

The purpose of China's intermittent opening for foreign banks and the slow change of regulations are to prevent too rapid a success of foreign banks' operations and to give local banks more time to enhance their efficiency (*Asiamoney*, 2000). With China's WTO entry, foreign banks also face a termination of tax exemptions that they were previously enjoying in their very limited scope of operations (*International Tax Review*, 2001).

CHAPTER 3

FOREIGN BANKS' OPERATIONS IN CHINA

3.1 Market Entry Strategies and Customers

Given the restrictions on foreign banks during the transition period, a common market entry strategy for them is to buy a minority stake in a Chinese bank. Through the Chinese bank, the FFI would have access to those businesses that are restricted, or that are not in line with the overall strategy of the FFI. Such a move can also allow them access to the local currency through the savings accounts of their local allies and thus evade the more expensive interbank market. Additionally, local partnerships and alliances have resulted for the sole purpose of co-operation for mutual benefit. For instance, Deutsche Bank entered into an agreement with Bank of Communications for an e-trading deal allowing the former to use the local bank's systems to access the accounts of the customers of the latter.

Foreign banks target smaller banks rather than the Big 4 in order to avoid taking over the huge NPLs from the Big 4. Smaller banks, in contrast, are not subject to policy lending and have relatively small amounts of NPLs.

A variety of possible market strategies exist for FFIs entering into China. Some banks like Deutsche Bank do not engage in retail banking and focus on business customers instead. Certainly, multinational companies (MNCs) are a targeted and well-received clientele, especially if the FFI has already conducted business with certain MNCs in other countries. Other banks like HSBC offer both personal banking services including RMB operations and corporate banking services through several branches in China. FFIs, like American Express target, the underdeveloped credit

card business in China and seek alliances with local banks to promote their credit cards.

MNCs are ideal customers for FFIs as they not only require RMB business, but also foreign exchange transactions and in most cases, already have established relations with international banks. However, FFIs are increasingly yielding to Chinese enterprises and individuals, too, in order to achieve reasonable growth rates for themselves. Their restrictions on RMB business can be overcome by alliances with Chinese banks. Chinese enterprises and individuals have thus far not experienced sophisticated asset management or credit management models since the existing models of the local banks are quite simple and not very developed. In this field therefore, foreign banks can benefit from their abundant international experience and from their sophisticated product portfolio.

Chinese individuals are a lucrative clientele because they have accumulated more than one trillion RMB in savings. It makes a lot of sense for foreign banks to target the wealthy individuals, an estimated population of 100 million to 120 million, who do not yet have sufficient access to suitable investment opportunities. Most foreign banks have a lot of knowledge dealing with such a category of customers in their home countries. Hence, unlike Chinese banks, for which this customer segment represents a new clientele that has not existed before, foreign banks can benefit by leveraging their expertise to their advantage in the Chinese market.

3.2 Risks

Foreign banks operating in China face a series of risks that may threaten their sustainability in the long term. The Chinese government has the right to impose changes in the banking regulations which may favour local banks during the transition period, e.g. by imposing geographical restrictions and additional capital

requirements to foreign banks' operations. Foreign banks have to be prepared for sudden changes and maintain flexibility until the banking sector completely opens up in 2007. Only banks with sufficient stamina will be able to survive in this environment.

Another threat is the outflow of operations know-how and technological skills, depending on the chosen mode of operation (e.g. JV or collaboration). FFIs may have to modernize operations of the allied local banks and be forced to provide their local partners with advanced marketing and IT skills without the security that this knowledge would be kept confidential.

FFIs holding a minority stake in Chinese banks must verify if there are overlapping customer segments which would lead to competition rather than collaboration with their ally. Consequently, most foreign banks limit their collaboration with local banks to an absolute minimum or prefer to operate alone.

During the transition phase, FFIs will not have access to Chinese savings accounts and have to use the more expensive interbank market to borrow Chinese currency from local banks. This disadvantage in the cost structure of RMB supply is a serious problem because many local enterprises and increasingly, MNCs as well, request credits in RMB.

Reliable statistical data is rarely available in China and therefore, market predictions are difficult. Even forecasts published in newspapers and magazines may not be very credible. These uncertainties have lead to cautious and hesitant investments by some FFIs such as DBS (Tan, 2003).

3.3 Opportunities

China, on the other hand, offers a number of opportunities for FFIs. The biggest opportunity is probably the fact that a vast amount of financial products just do not

exist in the present Chinese market. Such products include consumer credits, credit cards, asset management and pension funds, investment funds and so on, that are both successful and profitable in other countries. Since all these products are non-existent in China, there is undoubtedly an untapped potential for huge profits. Foreign banks have abundant expertise in these areas and can use them as leverage in the Chinese market. Most FFIs also have a low rate of NPLs and do not have to engage in the risky loan business with state-owned enterprises (SOEs).

As a result of China's WTO membership, imports and exports will grow at high rates and consequently, many enterprises will require banks that are adept in international transactions. Again, this is the playground of foreign banks while Chinese banks do not yet provide serious competition.

Foreign banks usually have streamlined and efficient operations and have enhanced their productivity and decreased their operational costs significantly over the years. This signifies a strong competitive advantage over the Chinese banks. FFIs also have a sound management system and efficient and transparent decision-making mechanisms (Mi *et al.*, 2002).

3.4 Overall Presence of Foreign Banks in China

The presence of FFIs in China is rapidly growing. Recent reports state that 214 representative offices and 190 business institutions are currently present in China, with combined assets of US$45.2 billion (Xinhua, 2002). According to the press release, 31 foreign banks have been issued licences to deal in RMB.

Forecasts of the market share that foreign banks can achieve in China vary greatly, depending on the source and the motivation of the source. Reliable estimations are currently not available.

CHAPTER 4

FOREIGN BANKS IN SHANGHAI

4.1 Role of Shanghai as a Financial Services Centre

Shanghai, whose name literally means "on the sea", is one of the world's largest industrial and commercial centres of the People's Republic of China. The city is the seat of the Shanghai municipality, an administrative entity that is equivalent to a province and is directly subordinate to the Chinese central government. The municipality covers a total area of 6,185 square kilometres, which includes the city itself, surrounding suburbs, and an agricultural hinterland; it is also China's most populous urban area with 18 million inhabitants.

Dated back to 1930s and 1940s, Shanghai used to be *the* financial centre in the Far East. The finance industry is well developed with a financial system that has evolved in recent years. The central bank is at the helm of the system with state-owned banks co-existing with various Chinese and foreign financial institutions. Major Chinese banks and non-banking financial institutions have set up branches in Shanghai. More than 20 foreign banks have made the Shanghai branch their regional headquarters in China. The total number of foreign-funded financial institutions has reached 65, including 54 banks and 11 insurance companies. Twenty-five of these foreign-funded banks are allowed to conduct business in RMB. In addition, the foreign banks' total assets and volume of deposits and loans account for more than 50% of the national total. Local authorities hope to attract more national financial institutions as well as foreign-funded financial institutions to move to or set up their China and Asia Pacific headquarters respectively in Shanghai.

With the further opening of its financial sector and improvement in infrastructure, Shanghai strives to build itself into an international financial centre, offering a variety of products and services, including a market for domestic interbank loans and national commercial paper. The city's financial sector will promote reform and innovation in the main board stock market while accelerating the development of a bond market and commodity futures market, as well as the construction of a reinsurance-trading centre. Shanghai will also develop foreign exchange trading and will actively prepare for the launch of a gold market, while making efforts to explore and establish offshore financial markets.

Shanghai's economic growth is extraordinary. In the last five years, it has achieved an economic growth rate of over 15% per year. It promises to maintain an average annual growth of 9% to 11% for the next few years, about 2-3 points above the national target. Such targets are taken seriously in China. With other areas of the economy struggling to keep pace, Shanghai needs a fast-growing finance sector to meet the benchmark. With enormous potential for banks and insurance companies, Shanghai, including the Yangtze River Delta area, is likely to make unlimited financial demands for supporting the economic expansion.

While domestic banks undergo restructuring and expansion, foreign banks are slowly gaining entry into the market. To sustain high levels of economic growth and to support the country's integration into the world financial system, measures have been initiated over the last few years which have further expanded the role of foreign banks in China. The following sections of this paper discuss the activities, strategies and challenges of some of these financial institutions.

4.2 Deutsche Bank AG Asia Pacific and Shanghai Branch

Deutsche Bank AG (DB) was founded in 1870 and ranks among the Top 20 of all Financial Institutions worldwide with a total market capitalisation of €48.8 billion (*Financial Times*, 2003) and total assets of €918 billion (Deutsche Bank AG, 2003). The bank offers a variety of financial products and services to private and corporate clients, including the full range of investment banking services. Further, DB is one of the leading providers of banking services, such as custody, cash management, asset management and private banking. The successful integration of the U.S. investment bank Bankers Trust in 1999 has strengthened DB's position in this business worldwide, enabling it to secure a strategic position among the top echelon of U.S. financial institutions. DB is capable of offering clients comprehensive services in the Americas, Europe and Asia Pacific. Today, 95,000 staff in 2,300 offices service close to 18 million clients in 70 countries around the globe. The bank is organised in three groups – Corporate and Investment Banking (CIB), Private Clients and Asset Management (PCAM), and Corporate Investments (CI).

The Asia Pacific region has always been an integral part of DB's strategy (Deutsche Bank AG, 2000). As per total assets under management, the bank ranks among the top 30 institutions operating in the Asia Pacific region (*The Asian Banker*, 2002b). DB currently employs over 6,000 staff in 13 Asian countries. In 1988, the bank established its head office for the Asia Pacific region in Singapore. Since then, the bank has been operating under a wholesale banking licence. There are two legal entities, which, under the Banking Act (The Monetary Authority of Singapore, 2001), offer the entire range of financial services (except for retail services) to local corporate and private clients in Singapore – Deutsche Bank Asset Management (Asia) Limited and the Deutsche Bank Singapore Branch (CIB and PCAM).

Deutsche Bank employs approximately 100 staff in Mainland China. In Shanghai, DB has been holding the status of a representative office since 1995 and converted into a branch in 1999. Since then, a number of licences have been acquired to conduct business in China through the bank's three offices in Shanghai, Beijing and Guangzhou. Beijing, currently operating as the sole representative office, is being considered for conversion into a branch in the medium term. The RMB licence has recently, in 2002, been issued to DB. Geographically, the Shanghai branch covers central China and parts of the East and West. The Beijing representative office covers the Northern provinces and cities, while the Guangzhou branch covers south China. The branches, like other branches in the Asia Pacific region, are organised in accordance with the world-wide group structure (Hamer, 2002).

Like other foreign financial institutions in China, the major competitive advantage is the wider range of products and the high quality of customer service offered. At DB, the single point of contact for a customer is the so-called Lead Relationship Manager (Lead RM), who is responsible for the customer throughout Mainland China. DB, in China, is mainly active with corporate customers that the bank services worldwide. The clear focus is on multinational corporations from the U.S., Europe (ex Germany) and Germany. Having been granted a license, Deutsche Bank would be able to maintain operating accounts with large local enterprises (LLC) in the short term. However, existing cross provincial regulations make it difficult for foreign banks to maintain operating accounts with local corporations.

The current restrictive regulatory environment and frequent changes present a hindrance in doing business. While most of DB's business in China is conducted with foreign corporate customers, cash management offers e-banking services to Chinese clients as well. The key focus on conducting business with local corporate

customers in China lies on offshore banking activities, for example IPO's, M&A, debt issuance, cash management and trade services in other countries in the event the LLC expands operations internationally. However, since investment banking business is not permitted through the Shanghai Branch, the same is conducted through the investment banking office in Hong Kong.

Compared to other foreign financial institutions, DB has entered the Chinese market relatively late. Consequently, there exists potential for developing new areas, such as domestic currency market and exploring profitable business opportunities. The bank is of the view that business will grow with the opening of the financial markets and Shanghai will further develop to become an important financial centre. Therefore, many of the bank's business and service divisions have been concentrated in Shanghai. In view of the local currency business, coupled with the gradual opening of the derivatives market (forward contracts, options, and swaps), Deutsche Bank can be expected to grow significantly.

4.3 Bank of America Shanghai Branch

Bank of America (BoA) is the largest domestic consumer and commercial bank in the U.S. with total assets of US$621 billion (Bank of America, 2003). Its 130,000 employees serve clients in more than 150 countries around the globe. In China, Bank of America Shanghai Branch – like Citibank Group – is striving to enter the retail banking sector as soon as the market becomes fully accessible. The bank entered China 14 years ago and is operating branches in Shanghai, Beijing and Suzhou, with a total of 33 employees.

Business opportunities with the growing number of net-worthy Chinese private clients attract foreign banks entering the retail market at this early stage. Clearly, the major focus lies in targeting the high-end customers with advanced services and

products not yet offered by the local institutions. Costs for setting up business in China, minimum capital requirements and a further capital injection of RMB100 million for acquiring the retail banking license make financial services an expensive and challenging business opportunity. Currently, business remains highly restricted and the bank's performance has negative effects on the consolidated balance sheet. Realistically, local alliance partners are necessary in the short run to gain access to the retail sector and to build up distribution channels throughout the major domestic markets. In addition, e-banking services and structured products are an improvement over the services currently offered by the Chinese Big 4 and therefore intended to satisfy customer needs better. However, similar to other foreign domestic markets, it is not expected that foreign banks will gain a major market share in China over time.

Competitive advantage of BoA lies in its human resources policy (incentive system for highly qualified local staff) and its ability to manage risk in accordance with international best practice. The bank's management focus on shareholder wealth and high rate of return will prevent the bank from entering business strategies which hurt the company's performance in the long-run.

BoA regards the competitive disadvantages for foreign banks' operations as twofold. First, the foreign banks' pricing strategy is currently less competitive in comparison with local banks, as a monthly fee is charged to account holders, a practice not instituted thus far in China. Second, the restrictions on accessing the local currency market significantly increases costs for providing funds to customers.

The impact of the current regulatory environment in Shanghai is significant. For instance, the main funding has to be sourced from the bank's capital or the interbank loan market, thereby inflating costs and binding working capital. Further, the RMB

foreign exchange conversion and funding is subject to strict regulations from the PBOC, which reduces flexibility. During the transition period between 2002 and 2006, Shanghai is expected to remain a fast growing business environment. Frequent changes in the regulatory and legal environment are sometimes viewed as an impediment, slowing the pace and hindering the requirements of more complex business.

4.4 The Development Bank of Singapore Ltd. Shanghai Branch

The Development Bank of Singapore Ltd. (DBS) is the largest bank in Singapore as measured by total assets, which accounted for S$151 billion in 2001 (DBS, 2003). In its home country, DBS holds the dominant position in consumer banking, treasury markets, securities brokerage, Singapore dollar loans, deposits and equity and debt fund raising. The current regulatory environment and restrictions for foreign banks operating in Singapore protect DBS from losing significant market share in the domestic market. Internationally, DBS has acquired the Hong Kong based Dao Heng Bank and DBS Dwong On banks operations, making it the fourth largest banking group in Hong Kong. Beyond its anchor markets of Singapore and Hong Kong, DBS is serving corporate, institutional and retail clients in Thailand, the Philippines and Indonesia.

In China, DBS is operating from two offices in Shanghai and Beijing. The bank entered the market in 1995 and is currently focussing on bond issuance, IPOs, US$-denominated lending, and restricted RMB business with foreign companies, i.e. Singaporean and foreign invested enterprises. There is no intention to enter the retail market in the short term. The bank foresees Shanghai as the future financial centre for China. Hong Kong would retain its role for the South China market and Singapore would serve clients in South East Asia. Though business opportunities in

Shanghai are growing as a result of the WTO liberalisation plans, the current regulatory environment and capital requirements hinder the bank from total market entry. Hence, Singapore and Hong Kong remain DBS's major business operations.

The advantage of DBS over its local competitors lies in the ability to offer supreme products and customer service to its clients. DBS also relies on its strong customer base from Singapore, which is entering the Chinese manufacturing and high-tech market. For DBS, cultural issues play a less important role in comparison with other foreign banks, as most of the expatriate staff is of Singaporean-Chinese background and hiring local staff is not considered an obstacle.

As state owned banks are able to offer cheaper loans to the local enterprises, it remains difficult to build up a local customer base. The bond and IPO market is still very restricted and access can be obtained through joint venture agreements only. However, like other foreign banks, DBS considers partnerships only in very exceptional cases.

The current regulatory requirements prevent foreign banks from total access to the financial services sector. The strict foreign exchange and capital controls further obstruct business in China. Business is being set up to the extent possible and the bank has to rely on its long-term earnings and business prospects. In other words, short term profits are not expected from the foreign bank's China operation. However, profits may be leveraged from the opening of capital markets through Qualified Foreign Institutional Investors agreements (QFII), which enable foreign companies in China to invest in specified instruments listed on the stock exchanges. The legal system, compared to other financial centres, is not yet comprehensive and developed to an extent that would ensure fair and transparent judgement in all business related juridical cases.

4.5 Dresdner Bank Group Shanghai Branch

Dresdner Bank Group (Dresdner) is one of the leading banking groups in Europe with total assets of €507 billion (Dresdner Bank AG, 2003). The bank's 1,120 branch offices and more than 50,000 employees are active in over 70 countries around the world. Since July 2001, Dresdner has been part of the Allianz Group as the centre of competence for banking. The combination of Allianz and Dresdner creates value addition to those customers who demand a wider range of financial and insurance products through broader sales channels and with greater advisory capacity and expertise.

In China, Dresdner has been present since 1980 and registered its first branch in 1990. The bank respects the Chinese culture and recognizes the necessity to build customer relationships at an early stage. Consequently, Dresdner is already experiencing the advantage of 'being among the first movers'. As the first among the around ten German banks with a presence in China (mostly representative offices), Dresdner has successfully applied for its RMB license and local business license (local customers). The bank is focusing on those business opportunities that are not currently offered by local banks such as trade finance and structured loans. Shanghai's increasingly modern infrastructure improves the accessibility of the local market. However, restrictions and limitations prevent the bank from reporting short term profits. Today, Dresdner's client base is predominantly located in Shanghai and consists of small and medium sized German and foreign enterprises.

Dresdner Bank leverages its competitive advantage from its strong ties with German SME's and Allianz Group's brand name. The management plans to gain access to the domestic retail market, SME market, wealth management and insurance market more intensively in the long run. Like other foreign financial institutions in

China, Dresdner Bank views its ability to offer specialised and niche products, such as structured deposit products and e-banking, and supreme services as the most important competitive advantage in the long run.

The domestic legal system, risk management practices and cultural differences pose obstacles in conducting business. In addition, concerns regarding human resources, possible know-how transfer and the ability to maintain sufficient capital base in a constantly changing regulatory environment are some of the risks experienced while doing business in China.

The current regulatory environment does not encourage or attract foreign banks to a satisfactory extent to form alliances with local partners. Hence, profitable business areas currently remain inaccessible for Dresdner Bank. However, as the regulatory and legal system matures and customer relationships are established, the bank hopes to achieve profitability and business growth in the coming years.

4.6 Bank of Communications Head Office Shanghai

Bank of Communications (BoC) serves as an example of how domestic banks try to cope with the changing environment after China's WTO entry. The bank was founded in 1908, the 34th Guangxu Year of the Ching Dynasty, and is China's fifth largest domestic bank with total assets of US$85 billion in 2001 (*The Asian Banker*, 2002a). Following the State Council's order in 1986, the bank was restructured and commenced business in April 1987. The head office has since been located in Shanghai (Bank of Communications, 2003). Traditionally, the bank has focused on corporate business throughout China, especially RMB lending. Recently, retail banking has become more attractive and a prospective area to enlarge business, for instance, in the areas of house mortgage loans, car loans and wealth management. The bank employs approximately 47,000 staff in more than 2,800 domestic business

outlets, 86 domestic branches and few overseas offices such as Hong Kong, New York, Tokyo, Singapore, London and Frankfurt. Interestingly, the bank has managed to advance its business practices over the past ten years and was awarded the title of 'The Best Bank in China' by financial magazines *Euromoney* and *Global Finance* in 1998 and in 1999, respectively. In the foreign exchange market, BoC is ranked second after Bank of China Group. In Shanghai, BoC regards the entry of foreign banks into the financial services market as both, risk and opportunity.

Foreign banks are viewed as having an advantage in hiring qualified talent from the local market. As they usually offer more attractive incentive packages, local banks are currently facing challenges in obtaining local talent. Conversely, local banks rely on their superior understanding of the local business culture and strong corporate spirit in order to retain qualified employees in the long run.

China's WTO entry has had a positive impact on the local banks thus far. BoC has continued its restructuring efforts in order to build competitive advantage over foreign entrants and the big four domestic banks. Increased competition also implies increased options for co-operation and clearly, local banks strive to share the advanced knowledge and expertise of foreign banks, i.e. in product development, foreign exchange and international trade. Consequently, BoC has forged a number of alliances with foreign financial institutions such as J.P. Morgan Chase (fund custody business) and Credit Suisse (syndicated loans). The bank anticipates a rapid transfer of knowledge in order to eliminate the current shortcomings of product know-how and expertise. The bank has recently introduced its first e-banking platform successfully to customers. For local banks, competitive advantage is based not only on their extensive branch network, but also on their in-depth understanding of the market's cultural aspects and access to the local currency market.

BoC, like foreign banks, views the current regulatory, legal and risk management environment to be less competitive and mature compared to other international financial services centres. However, the strong focus on reform and liberalisation, as well as the strong growth in manufacturing and high-tech industries support Shanghai's aim to become the regional financial centre in China.

CHAPTER 5

FINANCIAL SERVICES IN SINGAPORE: A COMPARISON

5.1 Role of Singapore as a Financial Services Centre

The International Monetary Fund (IMF) recognizes Singapore as one of the world's major offshore banking centres. Singapore's development as an international financial services centre began in the late 1960s as a stated government policy – one that it has pursued with vigour ever since. Singapore has developed a sound financial system within an economically and politically stable environment, which has attracted many multinational corporations and foreign banks. Today, Singapore plays host to some 6,000 multinational corporations and financial institutions serving as their global advisers, many of which use Singapore as their regional headquarters (Lee, 2001). In 1989 and 1990, financial services represented the leading growth sector in the economy, expanding by 22% in each of those years. Although the rate of growth in the sector has slowed considerably recently, this has been attributed largely to the consolidation of international banking and financial risk management activities worldwide.

In addition to its strategic location at the heart of Southeast Asia, Singapore, like Hong Kong, holds its favoured position by offering foreign affiliates four major business advantages (Eiteman *et al.*, 2001). First, low tax rates apply to foreign investment or sales income earned by resident corporations. In addition, a low dividend withholding tax on dividends is payable by the parent firm. Second, the Singapore dollar, despite the Asian crisis in 1997/98, has managed to remain a stable currency and permits easy conversion of funds into and out of the local currency. Third, Singapore intensively invests in infrastructure and facilities to support

financial services, for example, good communications, professional qualified office workers, a large expatriate workforce and reputable banking services led by an efficient and impartial legal system. Lastly, Singapore's fiscal policy and institutional framework ranks top in the world (IMD, 2002), increasingly encouraging the establishment of foreign-owned financial and service facilities within its borders.

Being one of the two major offshore centres in Asia, Singapore has developed into a full service banking centre that now aims to compete with London, New York, and Tokyo. Last year, financial services accounted for 11% of Singapore's US$85.6 billion GDP. Commercial banks' total assets and liabilities grew by 5.4% to reach S$344 billion at the end of 2000. In August 1999, the World Economic Forum Global Competitiveness Report ranked Singapore among the most sophisticated financial markets in the world. Ongoing measures to further liberalise the banking sector are aimed at attracting more top financial institutions to enter the market in Singapore. In addition, Singapore is actively promoting the development of specific markets and activities that have stronger growth potential, the wealth management industry being an example. Another example is the debt market, which traditionally has been underdeveloped across Asia.

5.2 Challenges for Singapore as a Financial Services Centre

Singapore is facing several challenges, most of which are a direct result of ongoing globalisation and the integration of financial markets around the world. Singapore's role as a major regional financial centre is closely tied to Southeast Asia's (SEA) political and economic stability, both of which have been seriously undermined by the aftermath of the Asian crisis and ongoing political instability. This has led to delay in tackling urgent economic, political and security reforms, particularly in

Indonesia. Economically, growth has been weaker and more disparate in SEA after the Asian crisis. As a result, portfolio and direct investment have fallen and moved to Northeast Asia, where China's immense economic growth is increasingly attracting the major portion of foreign direct investment (FDI). Singapore's strong export oriented economy is also dependant on the external demand by its major export partners – the U.S., Japan and the European Union (EU). All three markets, however, are still struggling to overcome the economic downturn of the past two years.

Singapore's domestic financial market is very small and still not fully liberalised. The extent to which foreign banks will be attracted to grow their operations here in the future remains questionable. Compared to other locations in SEA, the cost of operations is relatively high – e.g. labour cost and rents. In addition, foreign banks face a competitive disadvantage as a result of the government's protectionist policy towards the local banks. In the next section, this paper discusses the regulatory framework under which foreign banks operate in Singapore.

5.3 Singapore Banking and Regulatory Environment

About 700 local and FFIs are located in Singapore, offering a wide range of financial products and services. These include trade financing, foreign exchange, derivative products, capital market activities, loan syndication, underwriting, mergers and acquisitions, asset management, securities trading, financial advisory services and specialised insurance services. As of 1 March 2002, 121 commercial banks were licensed under the *Banking Act*, six of which were locally incorporated.

The Monetary Authority of Singapore (MAS) is Singapore's central bank, and has been rated 'The Best Central Bank in Asia' for three years in a row. Since 1970, MAS policies have protected local banks, especially in the retail banking sector. In May 1999, however, MAS announced a five-year programme to liberalise the

domestic banking sector in order to support the goal of becoming a premier global financial centre. The programme is aimed at strengthening Singapore's banking system and making local banks more competitive internationally. In June 2001, MAS announced the second phase of its banking liberalisation programme: free entry to the wholesale market by eliminating former restrictions, enhance competition further in retail banking by allowing more foreign players and introduce a new corporate governance framework. Still a noticeable disadvantage, Singapore's regulations still do not allow foreign access to local banks' ATM network.

With regard to capital requirements, a bank which is a qualifying subsidiary must, during the currency of its licence, maintain capital funds of not less than US$100 million, unless the MAS approves otherwise. As for tax incentives, Singapore encourages banks and merchant banks to undertake banking activities in Asian Currency Unit (ACU) with non-residents and provides a concessionary tax rate of 10% on income earned from such activities. Further, Singapore allows financial institutions with substantial international operations a concessionary tax rate of 10% on income derived from providing qualifying headquarter services to overseas related companies and on income derived from treasury activities. This tax incentive is extended to financial institutions using Singapore as a base for regional back office processing and regional data centre activities. Additional depreciation allowance may be provided where investments are capital-intensive in nature.

Foreign commercial banks may apply for three categories of licenses (The Monetary Authority of Singapore, 2002), in the absence of which the scope of business is limited. First, full-licensed banks are permitted to carry out the entire range of banking business approved under the *Banking Act*. A restricted number of those (currently six) are awarded Qualifying Full Bank (QFB) privileges. Banks with

QFB privileges are allowed to have 15 branches and/or off-premise automated teller machines (ATMs), of which up to ten can be branches. They are also permitted to relocate their existing branches and share ATMs among themselves. The restriction on debit services through an Electronic Fund Transfer Point of Sale System (EFTPOS), as well as on offering government linked retirement and investment services, has recently been lifted.

Second, wholesale banking licenses accommodate further entry of commercial banks into Singapore. Wholesale banks may engage in the same range of banking business as full licence banks, except that they cannot accept fixed deposits in Singapore dollars of less than S$250,000 from non-bank customers and they are not allowed to pay interest on current accounts in Singapore dollars operated by resident individuals.

Third, offshore banking licenses are issued to allow entry to more reputed foreign banks which conduct financial services business in non-domestic currencies. However, in addition to the conditions imposed on wholesale banks, offshore banks also may not accept interest bearing deposits from resident non-bank customers other than approved financial institutions and they may not extend total credit facilities in Singaporean dollars exceeding S$500 million (or S$1 billion in some cases) to non-bank customers who are residents of Singapore.

Besides the three categories of commercial banks, financial institutions may operate as merchant banks, which are governed by the Merchant Bank Directives, Notices to Merchant Banks and additional guidelines issued by the MAS. Typically, the activities of merchant banks include offshore banking, corporate finance, underwriting of share and bond issues, mergers and acquisitions, portfolio investment management, management consultancy and other fee-based services.

Lastly, finance companies may focus on providing small-scale financing, an area in which banks are less interested.

Given Singapore's small domestic banking market, not all foreign banks can be granted full bank licenses with QFB privileges. Currently, there are 22 foreign full banks, 33 foreign wholesale banks and 60 offshore banks operating within Singapore. At the beginning of the liberalisation in 1999, four foreign full banks were awarded QFB privileges, namely America's Citibank, Britain's Standard Chartered, France's BNP Paribas and the Netherlands' ABN Amro (Montlake, 2002). In 2001, two more financial institutions were granted the privileged QFB status – Malaysia's Maybank (ranked number five in ASEAN) and the London-based HSBC (*International Trade*, 2002).

5.4 Business Categories and Further Regulations

FFIs, licensed under the *Banking Act*, operate in the whole range of banking services in accordance with their specific licence. There are several statutes which have been of fundamental importance in establishing Singapore's legal framework for the finance sector (The Monetary Authority of Singapore, 2002): *Monetary Authority of Singapore Act* (1970), *Banking Act* (1970), *Insurance Act* (1966), *Currency Act* (1967), *Finance Companies Act* (1967), *Securities Industries Act* (1986), and *Futures Trading Act* (1986).

Singapore provides a well developed platform for equity and derivatives trading. The trading of equities is carried out on the Singapore Exchange (SGX) through its Securities Trading Division (SGX-ST). The SGX was officially launched in 1999 as the first de-mutualised, integrated securities and derivatives exchange in Asia Pacific. It provides an electronic platform for the trading of equities and a market operating a wide range of domestic and foreign securities. Member and non-member companies

are licensed as Dealers by MAS under the *Securities Industry Act* (1986). Consolidated shareholders' funds and adjusted net capital of the member companies were S$3,299 million and S$2,820 million, respectively. In 2001, the shareholders' funds of non-members reached S$1,439 million while adjusted net capital was S$469 million. Though Singapore's comparably young stock exchange is still ranked behind the more mature markets in Japan and Australia, the growth has been impressive. In 2001, there were 501 listed companies with a combined market capitalisation in excess of S$378 billion, compared to over 1,200 listed companies in Australia and 1,900 in Tokyo (Eun *et al.*, 2001).

The trading of derivatives products is carried out on the SGX through its subsidiary, Singapore Exchange Derivatives Trading Limited (SGX-DT). SGX-DT has grown into one of the world's leading derivatives exchanges, providing regional and international investors in Singapore with an effective global risk management and trading facility. Total trading volume was approximately 27.57 million lots in 2000, with an average daily turnover of 107,522 lots. All corporate clearing members are licensed by MAS under the *Futures Trading Act* (1986).

Takeovers and Mergers in Singapore are subject mainly to non-statutory rules in the *Singapore Code on Takeovers and Mergers*, which is administered by the Securities Industry Council (SIC).

Foreign exchange trading in Singapore has recorded an average daily turnover of S$115 billion. The predominant currency pair traded out of Singapore is US$/¥, accounting for 24% of all trades and €/US$ trades, 21% respectively. Singapore, as a foreign exchange market, ranks close to Japan and above Hong Kong.

Singapore, additionally, is fast emerging as a major centre for fund management activities in the region. To attract more fund managers to operate out of Singapore,

the minimum shareholders' fund requirement for an Investment Adviser's licence was reduced in 1998 from S$500 million to S$100 million. The minimum amount of global funds that the company must manage was also lowered from S$5 billion to S$1 billion. In addition, the government has introduced tax incentives that allow qualified fund management companies to enjoy tax exemptions for the fee income earned from providing investment management and advisory services.

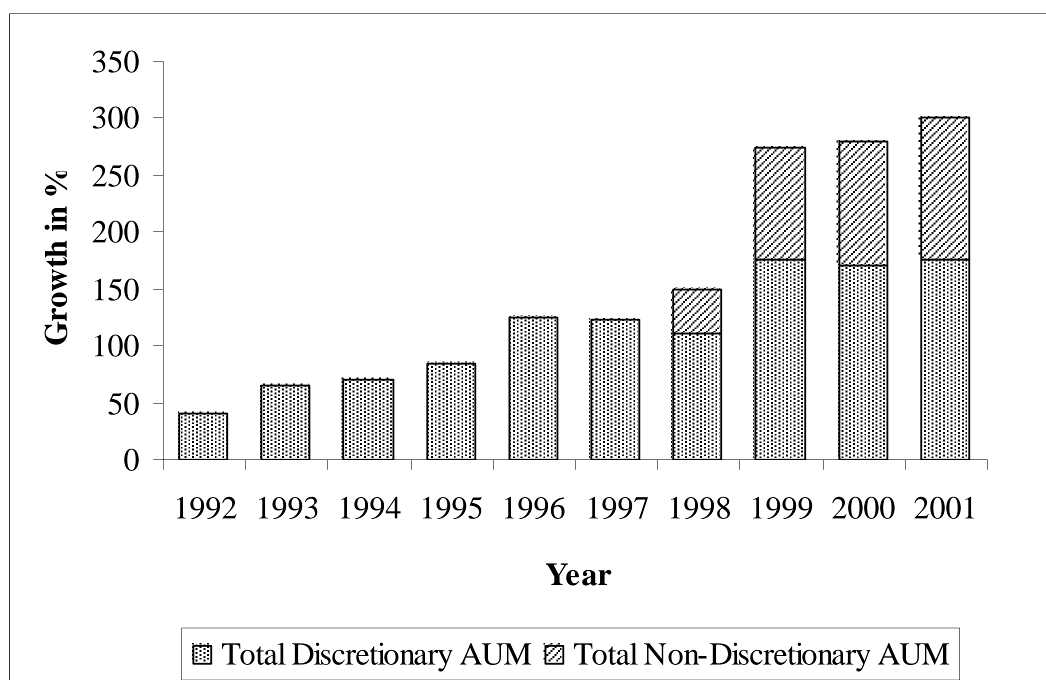
5.5 Future Growth Prospects

The volume traded on the SGX is expected to grow as the economy picks up in Southeast Asia. The Singapore Exchange offers new opportunities for market participants. For example, stock broking commissions have been fully negotiable since 1 October 2000. Members may now apply for dual membership of both SGX-ST and SGX-DT. Capital requirements for dealers have been lowered and tax incentives have been introduced to encourage growth of the equity and derivatives market. A concessionary tax rate of 10% will be granted to equity capital market intermediaries (ECMIs) on income derived from any security transaction denominated in foreign currency.

Furthermore, Singapore aims to strengthen its position as a major centre for asset management activities in the region. As most of the savings in Asian countries are still in the form of bank deposits, there is considerable scope for diverting some of these funds for professional management. In order to attract more foreign fund managers, the Government of Singapore Investment Corporation (GIC) has committed to place S$25 billion, and MAS has agreed to place S$10 billion, to be managed by fund managers based in Singapore. Despite the difficult market conditions in the year 2000, Singapore's wealth management industry has remained resilient. FIGURE 5–1 illustrates the continuous growth over the past ten years. At

the end of 2001, total assets under management in Singapore amounted to S$307 billion.

FIGURE 5–1
Growth of Assets under Management



Source: MAS (2001)

Singapore is also ambitious to grow its bond market. Singapore Government Securities (SGS) were initially issued to meet banks' needs for a risk-free asset in their liquid asset portfolio. In 1998, MAS spearheaded efforts to enhance the efficiency and liquidity of the bond market as part of its strategy to develop Singapore as an international debt hub. Since then, the bond market has grown significantly, making it one of the fastest developing centres in Asia. Total debt issuance volume increased by 43% to S$72 billion in 2001. Of the total issuance volume, 31% was in Singapore dollars and 69% in non-Singapore dollar-denominated debt.

Another promising area is electronic financial services. Singapore is actively involved in setting new policies on the electronic provision of services in the areas of banking, capital markets, risk management and third-party aggregators. In March 2001, formal supervisory guidelines on the use of the internet in banking (the Internet Banking Technology Risk Management Guidelines) have been released after extensive consultation with the industry in Singapore and abroad. Singapore has been contributing actively to the evolving thinking among regulators on these issues.

5.6 Local Competition and Co-operation within the industry

Competition and co-operation within Singapore's financial industry has long been regulated and supervised by MAS rules. Since 1999, the five-year programme to de-regulate the domestic financial services industry has aimed to spur competition by allowing greater access to foreign banks and to foster the consolidation of local banks.

Recently, in a move to further liberalise Singapore's financial services industry, MAS announced that the 40% ceiling on foreign ownership of local banks would be lifted. This move was followed by the removal of the 20% aggregate foreign shareholding limit on finance companies. Unfortunately, the proposed measures appear designed to facilitate the consolidation and enhancement of local banks rather than allowing foreign banks reasonable access to the domestic market. And while the new measures imply increased competition, the banking market in Singapore will remain protected with an institutional bias towards local banks. It has not been proven yet that foreign banks could gain controlling stakes in any bank without government consent. For many foreign banks, however, it is not a favoured policy to take minority stakes in a Singaporean bank as it could lead to brand dilution in the absence of a controlling stake (*The Business Times*, 2002). In addition, the fact that

MAS intends to keep the market share of local banks' domestic deposits at a minimum of 50% assures the local banks' access to most deposits (Williams, 1999). High customer loyalty of local clients also prevents foreign banks from gaining significant market share (i.e. in retail banking) quickly.

After the first few years of consolidation and merger activities, there are now three major local competitors offering commercial banking services in Singapore, namely DBS, United Overseas Bank (UOB) and Overseas Chinese Banking Corporation (OCBC).

DBS (merged with POSBank in 2000) is the largest bank in Southeast Asia, with 91 branches, more than 900 ATMs, and four million customers in Singapore. DBS is the local market leader, with a 24% market share of loans, 33% of deposits, 40% of residential mortgages, 20% of unit trusts, and 53% of IPOs. To foster internationalisation, DBS has completed several major acquisitions, including major stakes in Thai Danu Bank (1998), Hong Kong's Kwong On (1999) and Dao Heng (2001) banks. DBS reported S$151.3 billion in total assets and S$66.7 billion in total loans as of December 2001.

UOB acquired Overseas Union Bank (OUB) in 2001 and now ranks second in Singapore. The bank operates 68 branches and 359 ATMs and reported S$113.3 billion in total assets and S$60.9 billion in total loans as of December 2001.

OCBC Bank completed its acquisition of Keppel Capital (KC) in August 2001 and reduced its combined branches from 108 to 77. The number three bank holds S$85.2 billion in total assets and S$49.6 billion in total loans as of December 2001.

The three banks are competing in the same market segments for retail customers. DBS is the most internationalised and offers a wide range of international banking services. All three major banks in Singapore are still government owned. MAS

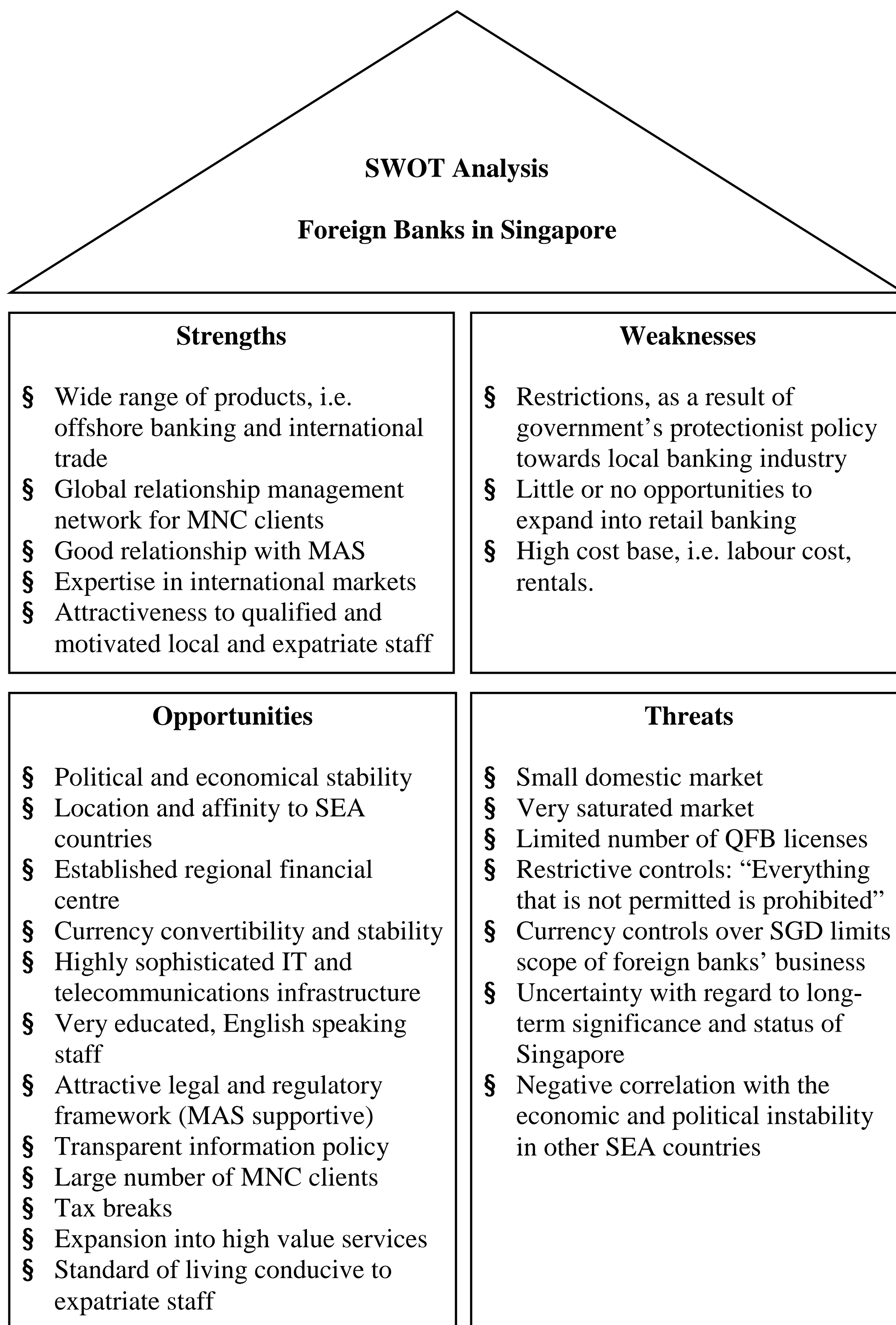
chairman Lee Hsien Loong said that, for the short-term future, the country's three remaining lenders would remain in Singaporean hands (*South China Morning Post*, 2002). However, actively leveraging their opportunities during the ongoing liberalisation programme, international banks have already expressed a long-term interest in chasing Singapore acquisition (namely Citigroup and Standard Chartered).

5.7 Conclusion

Despite the region's ongoing political, economic and social instability, Singapore manages to hold its position as an international, competitive, stable, and well-managed business environment. Onsite visits at the Singapore branches of Deutsche Bank AG and Bank of America have confirmed the general attractiveness of the existing environment – despite the restrictions imposed. FIGURE 5–2 summarises our findings and the resulting opportunities and threats for foreign banks in Singapore.

FIGURE 5–2

SWOT Analysis of Foreign Banks' Business Operations in Singapore



For risk-averse FFIs, Singapore will remain an attractive base for providing financial services in Asia. However, restrictions and regulations still prevent most foreign banks from entering the retail sector. Therefore, banks entering Singapore must consider other attractive areas.

Trade, especially intra-regional trade, offers great opportunities for the way ahead. China’s rapid growth offers new business opportunities and growth potential for Singapore as an international financial centre. By enhancing the critical framework, i.e. a sound regulatory system, corporate governance practices, a competitive educational system and an attractive living environment for foreign talent, Singapore will be able to retain its position. At the least, Singapore will continue to complement the services offered in emerging domestic centres with its wide range of offshore banking products.

Foreign banks would be wise to leverage the opportunities in specific areas, such as wealth management, equities and derivatives trading, debt markets and offshore activities. In addition, they should continue to tap their international network and expertise to bring new products and services to the local private and corporate customer.

To sum up, in the short-term, Singapore is expected to retain its position as an international financial centre in the region. However, in the long-term, it is uncertain whether Singapore would be able to maintain its favoured position for offshore banking activities and expand the areas of specialisation to offer even more banking services.

CHAPTER 6

RECOMMENDATIONS AND CONCLUSION

The purpose of this case study was to discuss the current business and regulatory environment for foreign banks entering China. In addition, the paper was to compare and contrast the regulatory framework in Singapore, an already established regional centre for financial services, with the one in Shanghai, a developing financial centre. Lastly, the major findings were to be discussed with foreign banks both in China and in Singapore, and final recommendations to be drawn for foreign banks expanding their business into China.

Earlier chapters have provided an in-depth analysis of the current business climate for foreign banks in both China and Singapore. Detailed information has also been provided on the regulatory framework within which FFIs have to operate in both countries. In order to provide a realistic picture of the economic, competitive and regulatory environment, extensive research has been conducted and findings discussed with industry experts in Singapore and Shanghai.

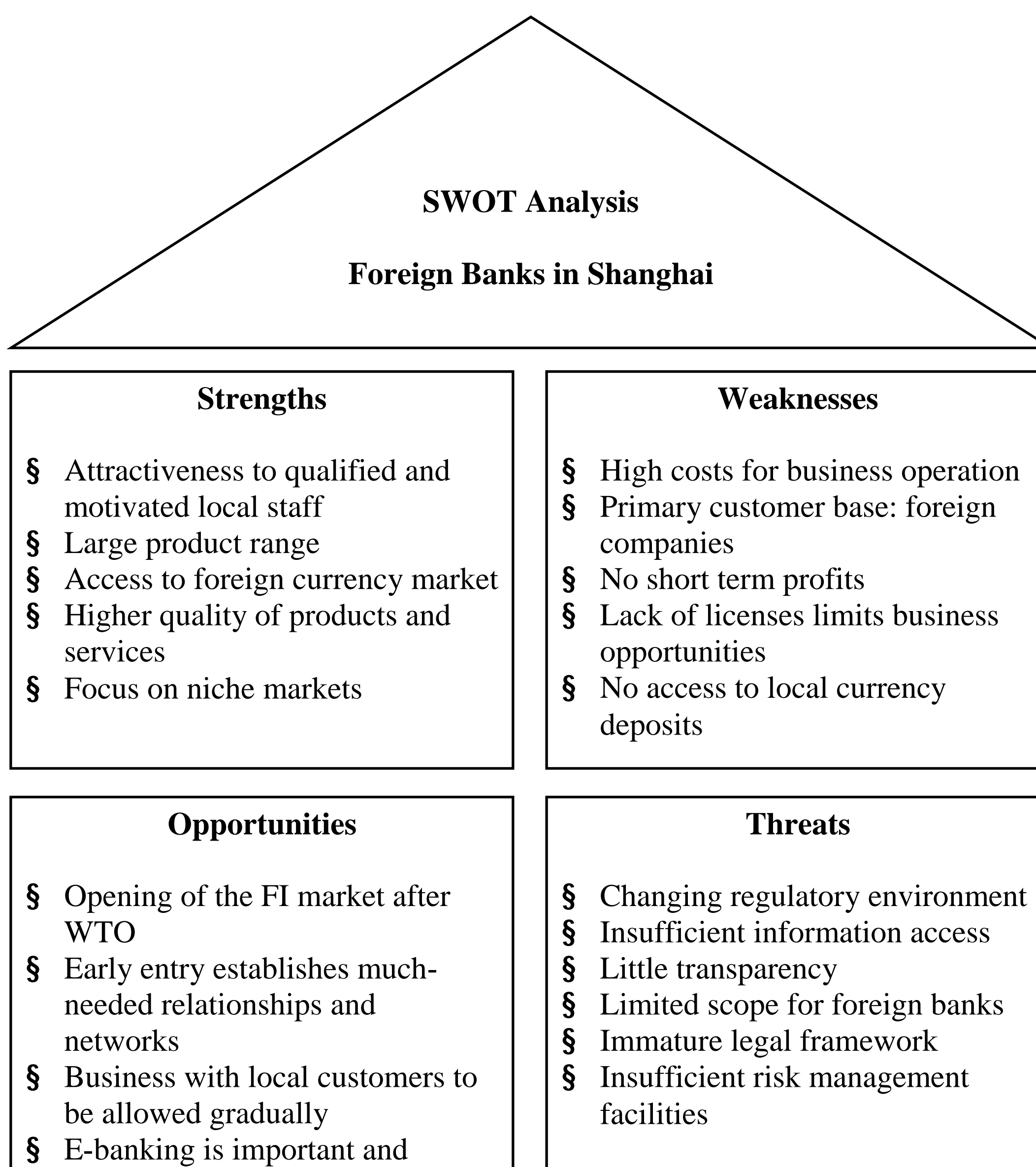
Notably amongst the findings, is the lack of satisfactory regulations and laws in Shanghai vis-à-vis the advanced and developed, albeit restricted, financial services environment in Singapore. Greater effort needs to be made by the Chinese government and the central bank (PBOC) to further enhance business opportunities, market attractiveness and profit potential for both local and foreign financial institutions. Nevertheless, despite the domestic shortcomings in China, most FFIs that have set up operations in the country, especially in Shanghai, over the last ten years, are very confident of expanding their customer base significantly in the years ahead. Shanghai's status as a major business centre in the People's Republic of

China makes it increasingly likely that the city will emerge as an important domestic financial centre in the medium or long term.

Conclusions on the findings of this paper, together with recommendations for foreign banks entering China, have been drawn out in the form of a SWOT analysis in FIGURE 6–1.

FIGURE 6–1

SWOT Analysis of Foreign Banks' Business Operations in Shanghai



A major strength of foreign banks today and in the near future is the capability to offer more comprehensive and higher quality products and services to customers. Foreign banks' access to the international money market and foreign currencies makes them attractive to multinational companies and firms engaging in international business. Consequently, FFIs should rely on their strengths in certain product or customer segments and aim to expand their business in chosen niche markets. Moreover, many institutions view the availability of qualified and motivated local staff as satisfactory and sufficient.

Conversely, a major weakness of foreign banks' operations in Shanghai is the current negative impact on the consolidated firm's balance sheet. Under the restricted regulatory framework, it is unlikely that significant profits will be generated in the short run. In addition, in the absence of necessary licenses and approvals, especially in case of late entrants, business opportunities are significantly curtailed. Early entrants, too, struggle to build a customer base in the local market. Therefore, in such a scenario, FFIs' primary focus is on foreign companies. The limited access to local currency deposits results in foreign banks acquiring the Renminbi currency via the interbank market. Consequently, interbank lending practices result in a further reduction of the bottom line.

Continuous and often-unforeseeable changes in the regulatory and legal framework pose a major threat to new entrants to the Chinese financial sector. The domestic regulator, namely PBOC, provides little transparency, resulting in inefficient business operations on account of insufficient information supply. The immaturity of the legal framework, too, is often criticised. However, China is aiming to reduce and eventually eliminate these obstacles in a speedy and transparent matter.

In order to draw a final conclusion to the above, we focus on the opportunities for foreign banks in China. First, it is a stated fact that China's entry into the WTO opens vast business opportunities for foreign companies and financial institutions alike. The effects and details are thoroughly discussed in Chapter 2. On-site experience of foreign banks in Shanghai has confirmed that early entry into the Chinese market provides an opportunity to establish the necessary networks with governmental and regulatory institutions, as well as profound and stable customer relationships with most foreign corporate clients. Lastly, in view of the present underdeveloped domestic financial market, described in Chapter 3, tremendous business potential exists, especially if foreign banks focus on their key strengths and product lines, exemplified in Chapter 4, and expand into markets that local institutions cannot currently satisfy.

A direct comparison with the SWOT analysis conducted in Chapter 5 indicates that major differences exist in the market opportunities and threats faced by foreign banks in China and Singapore. Although the strengths of the foreign banks against their local competitors are comparable in both markets, the level of business sophistication is too different to allow a complete comparison.

REFERENCES

Asiamoney, "What WTO means for Chinese banking", No. 11, July/August 2000.

Bank of America, "Facts", http://www.bankofamerica.com/facts/, 12 January 2003.

Bank of Communications, "Our Bank – History", http://www.bankcomm.com.hk/e_history.htm, 12 January 2003.

Câmara de Comércio e Indústria Luso-Chinesa – Delegação de Macau, "China and the WTO", http://www.ccilc.org.mo/pr020124.pdf, 12 January 2003.

Chan, E. G., Seminar presented to the NTU MBA BSM to Shanghai on Entrepreneurship in China, NTU Executive Centre, 8 November 2002.

Chen, J. and S. C. Thomas, "Banking on China", *The China Business Review*, 1 November 1999.

China Law & Practice, "What Opportunities do Foreign Banks Have in China?", Euromoney, 1 April 2002.

China Online News, "Depositor tries to sue Citicorp Shanghai branch over fees", http://www.chinaonline.com/default_020416.asp, 12 January 2003.

DBS, "Annual Report 2001", http://www.dbs.com/dbsgroup/annual2001/, 12 January 2003.

Deutsche Bank AG, Asia Pacific Head Office, "Commitment to clients from Deutsche Bank Group in Asia Pacific", June 2000.

Deutsche Bank AG, "Results 2001 Annual Report", http://group.deutsche-bank.de/images/ir/reports/2001eng/pdf/E_Results_01_orig.pdf, 12 January 2003.

Dresdner Bank AG, "Annual Report 2001", http://www.dresdner-bank.com/content/03_unternehmen/01_zahlen_fakten/04_geschaeftsbericht/01_geschaeftsbericht/01_uebersicht.html, 12 January 2003.

Eiteman, D. K., A. I. Stonehill and M. H. Moffett, "Multinational Business Finance", Addison-Wesley Publishing Company, Boston, MA, 2001.

Eun, C.S. and B.G. Resnick, "International Financial Management", Irwin McGraw-Hill, New York, 2001.

Financial Times, "Global 500 2002", http://specials.ft.com/spdocs/FT3BNS7BW0D.pdf, 12 January 2003.

Hamer, F., Seminar presented to the NTU MBA BSM to Shanghai, Deutsche Bank Shanghai Branch, 5 November 2002.

IMD, *IMD World Competitiveness Yearbook 2002*, IMD, Lausanne, September 2002.

International Tax Review, Vol. 12, September 2001.

International Trade, “Bilateral Agreements U.S.-Singapore Trade Talks to Address Customs Rules, Financial Services, IP Laws”, Vol. 19, No. 11, 14 March 2002.

Isinolaw Research Centre. “Foreign Investment Banks”, http://www.isinolaw.com/jsp/banking/commbk/COMMBK_foreign.jsp?LangID=0, Hong Kong, 12 January 2003.

Jorolan, D., “China: Banks’ role critical in QFII scheme”, *Asian Banker Interactive*, 20 December 2002.

Klein, M., Seminar presented to the NTU MBA BSM to Shanghai. 31 October 2002.

Lee, H. L., Luncheon Address by DPM Lee at the International Monetary Conference, “Financial Centres Today and Tomorrow: A Singapore Perspective”, Singapore, 4 June 2001.

Mi J., Y. Li and J. Huang, “The Challenges from the Opening of Banking Service Market in China”, Development Research Centre of the State Council Network, 13 January 2002.

Montlake, S., “Singapore Banks Take The Plunge”, *Financial Times*, 3 September 2002.

Ng, C. H., Seminar presented to the NTU MBA BSM to Shanghai, 6 December 2002.

South China Morning Post, “Limits on Foreign Ownership Remain”, 4 July 2002.

Tan, K. W., “What DBS can do for you in China”, http://www.dbs.com/sme/seminars/dbschina.ppt, 12 January 2003.

The Asian Banker, ”Strategic Business Intelligence for Asia’s Financial Services Community”, Journal Issue 36, October 2002a.

The Asian Banker, “Deutsche Bank reports pre-tax loss of 181 million euros for 3Q02”, 1 November 2002b.

The Business Times, “News Front”, Singapore, 3 August 2002.

The Economist, “The new spendthrifts”, 18 April 2002.

The Monetary Authority of Singapore, “Statutes, Regulations & Notices, Banking – Banks; Banking Act (Cap. 19)”, Singapore, 10 October 2001.

The Monetary Authority of Singapore, “Singapore’s Financial Sector, Banking”, http://www.mas.gov.sg, 3 September 2002.

The People’s Bank of China, “Measures on the Administration of Foreign Financial Institutions’ Representative Offices Stationed in China”, Beijing, 27 June 2002.

The People's Bank of China, "Senior PBC official talks on Regulations on foreign financial institution", http://www.pbc.gov.cn/trsweb/Detail.wct?SelectID=3152&RecID=10, 12 January 2003.

Trade and Industry Department and Trade Development Council, "Embracing the Opportunities, Meeting the Challenges – Special Supplement on China's Accession to the WTO", http://www.tdctrade.com/wto/index.htm, Hong Kong, 12 January 2003.

Williams, B., "Banking System Update – Singapore Financial Services Deregulation – Cautious Freedom", Fitch Ratings, New York, 19 May 1999.

Xinhua, "China to Open Banking Sector as Promised", Beijing, 1 February 2002.

Yadong, L., Guanxi and Business, World Scientific Publishing Company, Singapore, September 2000.