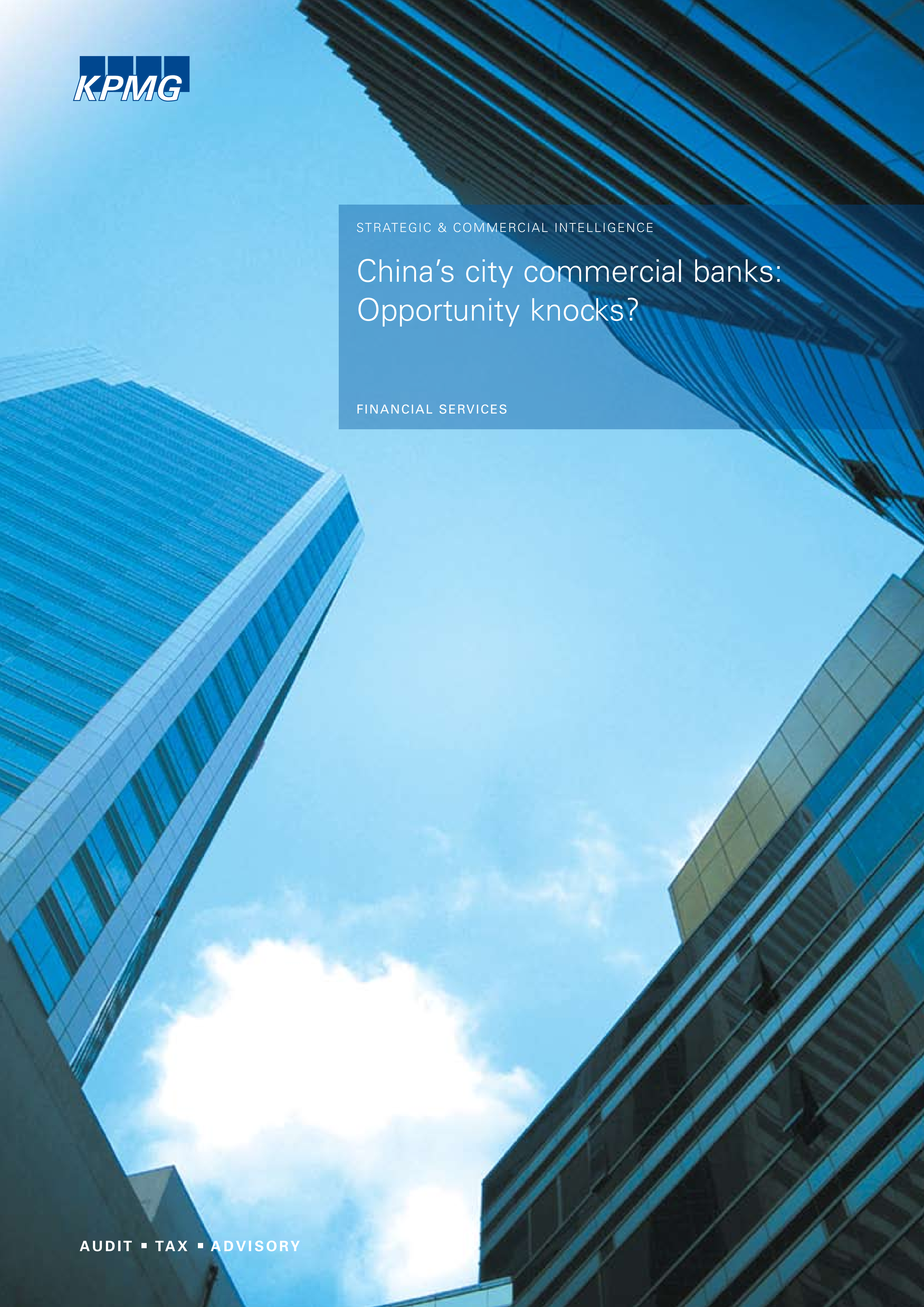

KPMG

STRATEGIC & COMMERCIAL INTELLIGENCE

China's city commercial banks: Opportunity knocks?

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Preface

There has been mounting interest in China's large and problematic banking sector as foreign institutions continue to jockey for position.

Government regulators have been focused on solving the systemic problems that plague the industry while foreign investors have been opening their wallets to purchase stakes in joint-stock banks. Less is known however about the 'third-tier' city commercial banks and the opportunities (and risks) they present foreign investors.

Some would argue the risks are high — that the city commercial banks have even greater problems than the four massive state-owned banks, with high non-performing loan ratios, poor capital adequacy ratios and limited market penetration. Not to mention city commercial banks have significant local government influence and management systems that are often years behind international standards.

Yet a number of foreign investors have purchased stakes in city commercial banks and an even larger number are standing in line for their chance. What is it that they see that the sceptics don't?

KPMG has researched the sector and interviewed a number of banking executives, some of whom had entered into deals to invest in city commercial banks. Our objective is to provide fact-driven analysis and informed views on the opportunities and risks within the market.

The key findings of the report are:

- City commercial banks can indeed provide an entry into the China banking market for a relatively low cost — but investors need to be realistic.
- City commercial banks suffer from the same problems plaguing the banking sector in China — such as high non-performing loan ratios and low capital adequacy ratios.
- The quality varies among city commercial banks and there are now few decent city commercial banks available.
- City commercial banks are not only looking for capital: they are also looking for products, management and systems — foreign banks are more likely than a local institution to be able to offer these.
- Only with a long-term strategic view does an investment make sense, and even then, investors must be prepared to invest a substantial amount of time and effort into making it work.

Paul Brough

Head of Financial Advisory Services, China and Hong Kong SAR
KPMG
May 2005

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- KPMG in Hong Kong does not accept responsibility to any party that relies on information or views expressed in this report; such parties should seek professional advice and conduct a thorough assessment of the particular situation prior to making any business decision.
- Our report is based on information available to us at the middle of May 2005. Our information and analysis is based on research and interviews conducted during April and May 2005.

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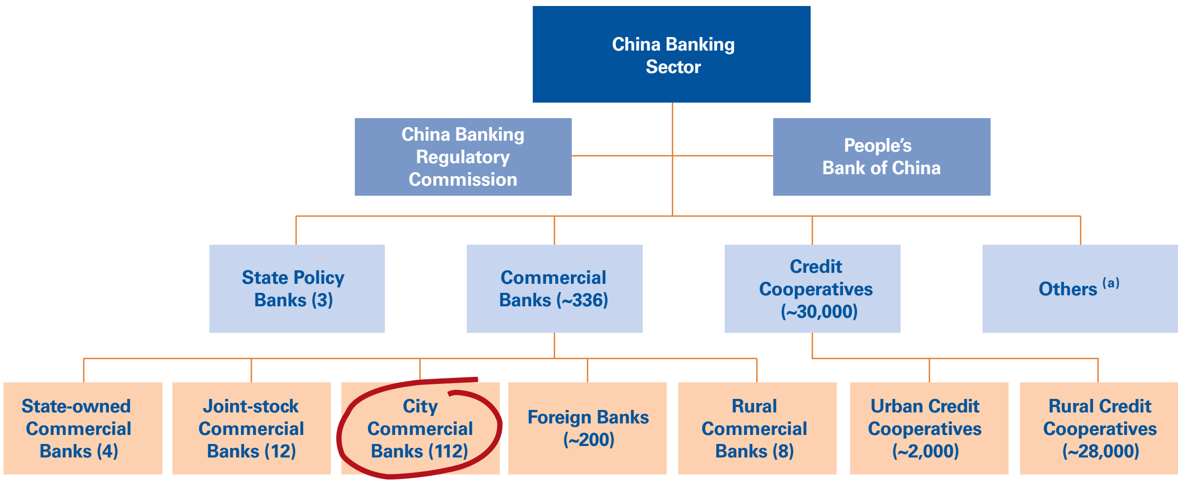
China's city commercial banks

China's city commercial banks have had a short — and arguably not very successful — history in China's banking sector. They were created during the 1990's by city governments through the active merging and restructuring of China's 5,000 or more urban credit cooperatives to resolve a number of issues that had developed within the sector.

The first city commercial bank to be established was Shenzhen City Commercial Bank in 1995. By the end of 1998 the initial wave of restructuring had created 88 city commercial banks, leaving 3,240 urban credit cooperatives.

Since then still more city commercial banks have been formed, so that today the number stands at 112 city commercial banks and around 2,300 urban credit cooperatives.[1]

China banking sector overview 2005



Notes: Number of banks in brackets
(a) Includes postal savings and other non-banking financial institutions
Source: KPMG analysis of publicly available information

The role of regulating the banking sector in China was originally held by the People's Bank of China (PBOC); since 1998 responsibilities are now divided between the PBOC and the China Banking Regulatory Commission (CBRC):

- The PBOC, under the guidance of the State Council, is responsible for formulating and implementing monetary policy while enacting safeguards to ensure financial stability in the economy.
- The CBRC is the main regulator of the banking sector, responsible for, among other activities, formulating and enforcing the supervisory rules and regulations governing banking institutions.

(1) The China Business Review "Banking in China" Dec 1999; Asian Wall Street Journal "City lenders offer foothold for international investors in fast-growing market" Feb 2005

City commercial banks were originally part of the city government's economic planning apparatus when they operated as urban credit cooperatives, and although they now form part of the State's central economic planning apparatus, they often maintain very strong ties to their respective city governments — city governments still hold an average 75 percent share of the banks(2).

Few city commercial banks have any substantial private investment and none of the banks are listed. Under the influence of the local government, city commercial banks have typically been vehicles to finance government projects.

Statistics from the CBRC indicate that around 70 percent of loans from city commercial banks are granted to state-owned and private small and medium enterprises (SME) that operate within the city boundary — the regulatory limit placed on where city commercial banks can operate branches.

Geographic limitations are not the only limits to operations: city commercial banks are also subject to other regulatory specifications, such as:

- A minimal capital requirement of RMB 100 million (USD 12 million) — compared to RMB 1 billion (USD 120 million) for joint-stock commercial banks and RMB 50 million (USD 6 million) for rural commercial banks.
- A requirement to reduce their non-performing loans (NPL) ratio to 15 percent by the end of 2005.
- A necessity to maintain a capital adequacy ratio (CAR) of eight percent.
- From 1 January 2006, city commercial banks will be required to comply with the PBOC's 2002 Provisional Rules on Information Disclosure of Commercial Banks, requiring them to disclose financial statements and provide information on their risk management and corporate governance activities.

City commercial banks are considered to have a key role in financing the SME segment of the economy, which is considered by some to be an important factor in China's development; as Xu Dianqing, a researcher at the China Centre for Economic Research, stated in the press:

"These [city commercial banks] have generated enormous loans to small and medium-sized enterprises, which have become the backbone of the country's economy." (3)

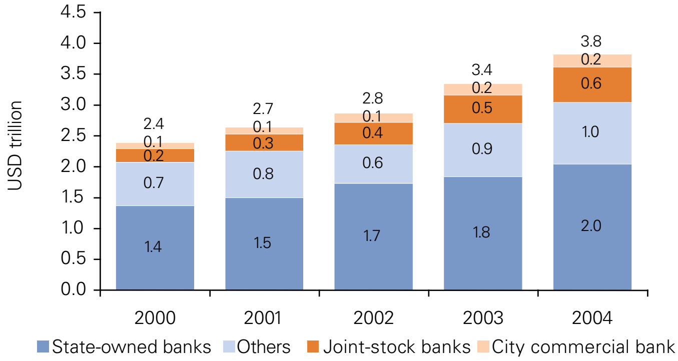
Although they play an important role in their local banking sector and in serving an important sector of the economy, in terms of the overall Chinese financial services sector the reality is that city commercial banks are still small fish in a big pond.

(2) Development Research Center of the State Council Network "Findings from a city commercial bank survey" Feb 2005
(3) China Business Weekly "Foreign banks eye up local lenders" Jul 2004

A dot on China's banking landscape

By any measure, China's banking sector is massive. Assets have grown at a compound annual growth rate (CAGR) of 13 percent since 2000 and stood at USD 3.8 trillion at the end of 2004, around the size of the United Kingdom's.

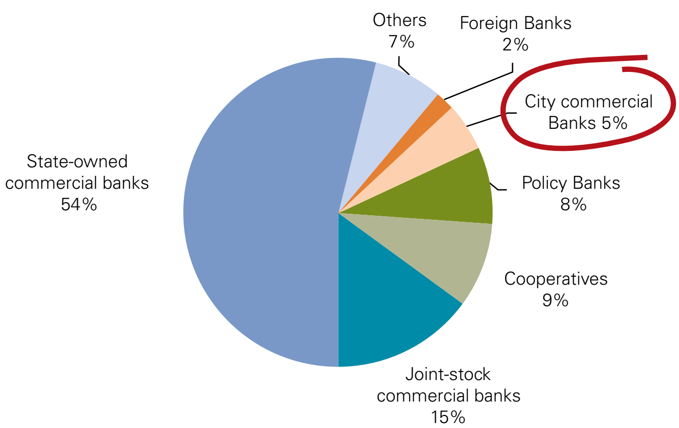
China banking industry assets 2000-2004



Sources: KPMG analysis of Economic Post "China Banks' non-performing loans continue to decline" Jan 2005 and Economist Intelligence Unit "China financial services background" May 2005

China's 112 city commercial banks together account for just over five percent of the Chinese banking sector's assets. They are overshadowed by the Big-Four state-owned commercial banks (Agricultural Bank of China, Bank of China, China Construction Bank and Industrial and Commercial Bank of China) which hold over half of China's banking assets, and the 12 fast growing joint-stock commercial banks[4], which together hold 15 percent of assets.

China banking industry share by assets 2004



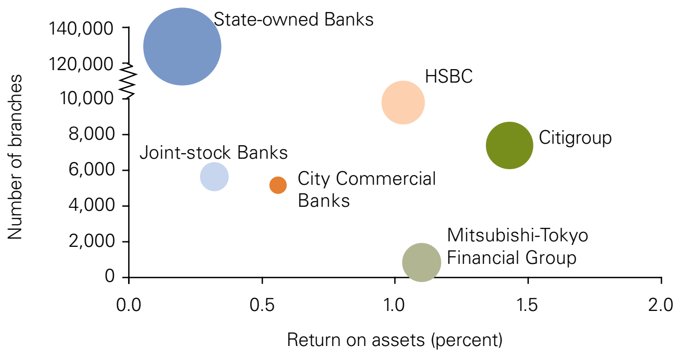
Sources: Asian Wall Street Journal "City lenders offer foothold for international investors in fast-growing market" Feb 2005; China Banking Regulatory Commission website, May 2005

(4) Joint-stock commercial banks are either wholly or partially privately owned and often have a license to operate nationally

Some context is needed, however. City commercial banks, although small by comparison to other banks in China with regard to assets, often serve cities the size of small countries. For example, Bank of Beijing, Bank of Shanghai and Chongqing City Commercial Bank all operate in markets with populations of over 10 million.

In terms of network coverage, 50 branches is typical for a city commercial bank although some have over 200. While this pales in comparison to the state-owned banks (which have tens of thousands of branches around the country) the city commercial banks have solid market positions in their respective cities: most are the fourth or fifth largest bank in their respective market and in some cases within the top three.

Comparison of Chinese and international banks by total assets, return on assets and number of branches 2004



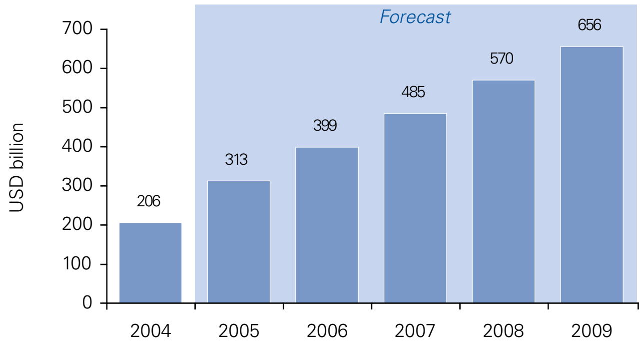
Notes: Size of bubble denotes total assets
Total Assets and Return on Assets for state-owned banks, joint-stock banks and city commercial banks are industry averages

Sources: KPMG analysis of China Financial Yearbook 2004, bank annual reports, press releases and media reports

No city commercial bank has a return on assets of greater than one percent, with the average being around 0.56 percent, under China Generally Accepted Accounting Principles (GAAP). While this may not compare favourably against some major global banks, this performance is better than that of other categories of banks in China — if the official figures are considered reliable.

City commercial banks are projected to continue to grow at a healthy rate in line with China's overall economy and the banking sector; one forecaster anticipates city commercial banks to grow at a CAGR of 26 percent to reach nearly USD 656 billion in assets by 2009[(5)].

City commercial bank assets 2004 - 2009



Source: CCID Consulting "2004-05 China city commercial banks research report" Apr 2005

This appears to be a challenging growth rate to sustain, and a number of significant issues would need to be managed to achieve this, such as: strategic risk, poor corporate governance, small scale, weak risk management, high NPL ratios, and low CARs.[(6)]

(5) CCID Consulting "2004-05 China city commercial banks research report" Apr 2005
(6) China Banking Regulatory Commission "The fourth meeting of PRC city commercial banks" Aug 2003

No immunity from China's banking issues

Chinese banks have historically invested a large portion of China's significant bank savings in state-owned enterprises — though rarely in an efficient manner. This has resulted in a significant build-up of NPLs.

The government figure for the NPL ratio of state-owned commercial banks was 16 percent at the end of 2004(7), however, some external estimates believe this may be understated and that it could be much higher.

This issue has received a great deal of attention in recent years, with government efforts focused on such areas as:

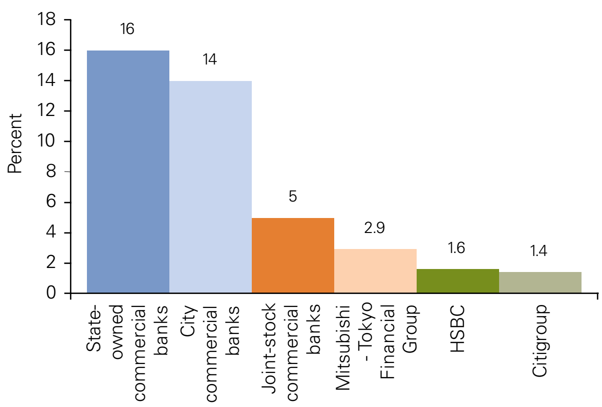
- improving the quality of the banks' loan portfolio
- rationalising the state-owned industrial sector
- decreasing the length of time it takes to write-off NPLs
- encouraging banks to lend to private firms and individual consumers

Some key banks have been recapitalised by the government, while others, including city commercial banks, have been encouraged to reduce NPL ratios through writing off bad loans or selling them to specially established asset-management companies.

The Chinese government has also planned on injecting substantial sums into the state-owned commercial banks in order to help improve NPLs: Bank of China and China Construction Bank were reported to have each received USD 22.5 billion last year, while the Industrial and Commercial Bank of China has reportedly received USD 15 billion recently.

As a result, NPL ratios have been decreasing, but are still some way off from reaching international levels.

Comparison of non-performing loans 2004



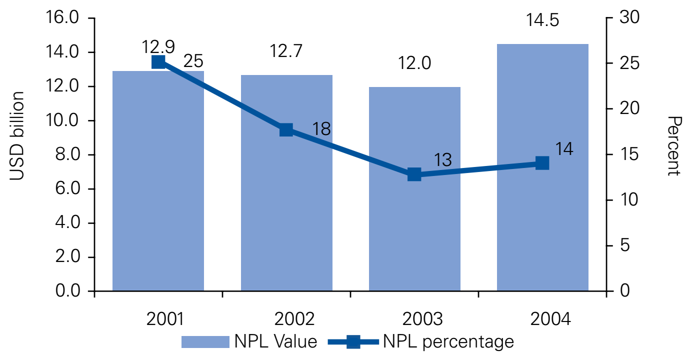
Sources: China Banking Regulatory Commission website May 2005; Mitsubishi-Tokyo Financial Group annual report 2004; HSBC annual report 2004; CIBC World Markets "Citigroup" Mar 2005

(7) China Banking Regulatory Commission website May 2005

City commercial banks have some of the worst NPL ratios in the industry and government has told individual city commercial banks to reduce their NPL ratio to below 15 percent by the end of 2005. Some city commercial banks have taken positive action against NPLs, with Hangzhou City Commercial Bank implementing asset replacement in 2002, followed by Qingdao City Commercial Bank: there are similar proposals to local governments from around 50 other banks.[8]

These efforts have helped to bring the average NPL ratio for city commercial banks down to around 14 percent from 31 percent four years ago. However, some city commercial banks are still thought to have NPL ratios of over 50 percent.[9]

NPLs in city commercial banks 2001 - 2004



Sources: CCID Consulting "2004-05 China city commercial banks research report" Apr 2005; KPMG analysis

City commercial banks have also been told by the CBRC to improve their CAR, which stood at under six percent — notably below the eight percent set as a minimum by the capital adequacy standards established by the 1988 Basel Accord.

Other banks in China do not have much higher CARs, with state-owned banks typically hovering between six and eight percent — whereas most international banks have CARs of between 9 to 11 percent.

(8) Development Research Center of the State Council Network "City commercial banks should get rid of the image of being local financial institutions" Jan 2005
(9) Economist Intelligence Unit "China financial services background" May 2005

Is government influence to blame?

Many of the city commercial banks' issues have stemmed from poor risk management procedures and unrestrained lending to government-linked enterprises and projects. This problem has been widely attributed to the level of local government control in the banks.

But is the story quite so black and white? A survey by the Development Research Center of the State Council Network in China concluded that there is no direct relationship between the percentage of local government's share in a city commercial bank and the operating performance and efficiency of banks (based on NPL ratio and return of asset analysis).[10]

However, industry executives interviewed by KPMG held the view that the greater the influence of the local government on the issuance of loans, the greater the likelihood of performance problems — and the level of ownership does not always reflect the true level of control. One executive of an international bank told KPMG:

"The further away the bank is from central government or economic centres, the more you have to be concerned about local government influence."

Whatever the cause of the problems, it is evident that both the CBRC and the majority of city commercial banks are keen to improve the quality of performance and management as:

- They are under increased pressure from government to resolve systemic issues and will not be able to rely on government in the future to assist them financially.
- They need additional capital to resolve their issues and fund future growth while improving risk management systems.
- Increasing competition from other commercial banks is challenging their market share.
- The Big-Four state-owned commercial banks and the joint-stock commercial banks do not appear to be interested in merging or acquiring them.

(10) Development Research Center of the State Council Network "Findings from a city commercial bank survey" Feb 2005

Moving ahead

The CBRC has its hands full with the daunting task of reforming the state-owned banks and many systemic problems. City commercial banks have not been ignored, but neither are they as high a priority.

The regulator has provided city commercial banks with guidelines to achieve set targets[11]:

1 From 2004, banks should strengthen capital controls and set themselves a five year plan to achieve improved capital adequacy ratios;

2 Banks should better control loans to connected parties and should prohibit loans to shareholders;

3 Banks should improve transparency, establishing effective channels and systems to release bank-related information to outside parties; and

4 Banks should improve their market competitiveness through reorganisation, mergers and acquisitions, or the introduction of foreign or local investors.

However, the CBRC has not provided detailed measures on how these guidelines should be implemented. As a result, city commercial banks have tried a variety of methods to effect change.

Consolidation down the road

It is unlikely that the CBRC would allow any of the city commercial banks to fail and it is expected to become more involved once issues in other areas of the banking industry are resolved.

As Liu Mingkang, Chairman of the CBRC, commented at a conference of city bank chiefs three years ago, the government is prepared to weed out the weak performers rather than wait for them to become insolvent.[12]

This view appears to have held fast and there looks to be an increasing divide among the 112 city commercial banks: a number of them seemed to have improved quite considerably, while a large number appear to be standing still.

This inactivity by most of them may simply be because many of the banks are still learning the ropes: they are all young banks (less than 10 years old), and many have been formed out of urban credit cooperatives with very different corporate cultures. As Wang Shihao, Chairman of the China City Commercial Bank Fund Clearing Centre, commented in the press:

"The city banks generally lack specific specialities and niches and have had difficulties in exploring new markets and business opportunities outside of the local governments, their biggest shareholder." [13]

Some commentators predict that in about five years time the number of city commercial banks will be whittled down to between 30 and 50. During an interview, an executive of an international retail bank told KPMG:

(11) CCID Consulting "2004-05 China city commercial banks research report" Apr 2005
(12) Economist Intelligence Unit "China Hand" 2004
(13) The Asian Banker Journal "City banks band together" Feb 2005

"Eventually, the number of city commercial banks will reduce — but for the moment, government is letting them sort out their own problems."

The need for a capital injection

Many of the city commercial banks have been looking for outside investment from both local and international investors. Fresh capital and expertise is viewed as a key step to strengthen their market position.

This has been encouraged by the CBRC: Vice-Chairman Tang Shuangning has urged the country's city commercial banks to:

"Restructure themselves and strengthen their capital bases by introducing strategic institutional investors from both home and abroad." (14)

While Xu Dianqing, a researcher at the China Centre for Economic Research, emphasised the need for increased finance and improved risk management procedures, commenting in the press:

"Lack of new capital injection has hindered the expansion of city commercial [banks]. Financial risks will soon accumulate in the system if these banks fail to improve their corporate governance." (15)

Strategic partnerships - another option

Introducing foreign and local investors has not been the only approach, as a number of city commercial banks have looked to establish strategic partnerships with their peers from other cities.

In recent years, some city commercial banks have been developing strategic alliances. For example(16):

- In 2001, Shenzhen, Nanjing, Guiyang, Wuhan, Hangzhou and Dalian developed a strategic cooperation framework;
- In 2002, a Northeast city commercial bank alignment was developed, led by Dalian City Commercial Bank with 13 other banks;
- In October 2002, Bank of Shanghai established the first city commercial bank clearing house and extended access to other city commercial banks; and
- In May 2004, Nanjing City Commercial Bank aligned with 15 city commercial banks to establish two investment centres for inter-banking securities capital with operating assets of around USD 22 million.

However, due to regulatory limitations on geographic boundaries as well as the localised nature of their customer base, strategic partnerships appear to have limited impact on cross-selling opportunities. As one interviewee commented:

"For as long as [city commercial banks] are subject to [boundary] restrictions, I can't see how strategic partnerships will help them much."

(14) China Business Weekly "Foreign banks eye up local lenders" Jul 2004
(15) China Business Weekly "Foreign banks eye up local lenders" Jul 2004
(16) Development Research Center of the State Council Network "Development of PRC city commercial banks" Mar 2005

Boundary restrictions may eventually relax

Eventually, though, we will probably see a gradual relaxation of these boundary restrictions. By some accounts this is actively encouraged, as Chen Yuan, the CBRC sub-division head, commented in the press:

"Once the city commercial banks reach the standards set by the regulators, they will be encouraged to go beyond their regional markets to compete with other city commercial banks in other regions." [17]

It is unlikely that the current geographic restrictions will be fully relaxed within the next five years, by which point some of the banks may look to merge or acquire as a means to move across boundaries. This may be a well-intentioned approach to reducing the costs involved with improving risk management systems, but without understanding the local market, it may not help expand their customer base and market position.

In due course, the CBRC will allow city commercial banks to operate beyond city boundaries in order to survive. This will certainly make them more attractive targets to foreign investors, but there is still some scepticism over whether this will help them gain substantial market share in China's overall banking market. As one report commented:

"Although regulations are changing to allow these banks to open branches outside of their respective cities, it is unlikely that they will ever grow beyond the...market share they individually hold currently." [18]

(17) China Business Weekly "Foreign banks eye up local lenders" Jul 2004
(18) The Asian Banker Journal "City banks band together" Feb 2005

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What's the attraction?

Interest in city commercial banks from foreign investors has been increasing in recent years — as a mode of entry into China's rapidly growing banking sector and an opportunity to make returns.

Foreign investors have long been attracted by China's underdeveloped financial markets and high personal savings but their participation has been subject to various restrictions. As a result, foreign investors have looked at city commercial banks as an opportunity to access such fledgling product areas as private loans, credit cards, and insurance and fund distribution. KPMG interviewed an executive of an international retail bank who commented:

"City [commercial] banks are a good opportunity for getting into a growing and under-penetrated market. But you have to take your time — it will not happen overnight."

"It's a very low-cost option of learning in China. It's paying for tuition."

Head of the Financial Institutions Group in Asia for J.P. Morgan Chase [19]

The financial risks are often seen as small

Foreign investors can take a maximum of 19.9 percent in a city commercial bank with total foreign investment limited to 24.9 percent. Investments so far in a city commercial bank have ranged from USD 15 million to USD 215 million — not usually a significant investment for an international bank and as one media report described it, these are acquisitions that "...hardly register a blip on their books." [19]

However, there are potentially other risks to be concerned about, as one KPMG banking professional explained: "There are risks: the bank's reputation if the deal fails and if the [city] government locks you in and expects you to bail out the bank."

Foreign investors can't buy control

There is also the concern that an investment may buy a significant stake, but it won't give the bank control.

For some investors, control is more important than for others. A 20 percent stake in a city commercial bank will typically allow a bank two seats on a 15 person board. However, some investors seek more and some seek less, for example[20]:

- For their 17.89 percent stake in Shenzhen Development Bank (a joint-stock bank), Newbridge Capital placed an acting president and six of 15 board members;
- Commonwealth Bank of Australia will get one seat on the 15 member board for its 19.9 percent stake in Hangzhou City Commercial Bank.

The issue of control depends upon the investor, as one banking executive told KPMG in an interview:

"Board seats are useful but not essential. To us, having our people in key positions at the operational level was more important. This is where the changes are made."

(19) Asian Wall Street Journal "City lenders offer foothold for international investors in fast-growing market" Feb 2005
(20) South China Morning Post "Australian lender takes hands-off tack" April 2005

City commercial banks are also looking for something

Foreign investors are not the only ones looking to gain from these investments — the city commercial banks often have a clear agenda of their own. City commercial banks are not just looking for additional capital to fund changes in their management systems and new growth strategies, they are also looking for technical expertise in risk management and product development: this is know-how that foreign investors are usually willing and able to bring to the table.

"The local banks are usually hungry for technical expertise. They recognise they have problems and are looking to the foreign investor to bring solutions."

- KPMG interview with an executive of an international retail bank

To many investors, though, the opportunities clearly outweigh the risks. To date, seven deals have been made with city commercial banks with several more under discussion (refer to the following page for details).

So far, it has been too early to tell whether any returns will come from these investments. Banking executives we spoke with generally held the view that it will be another five years before anyone can tell if these investments have been worthwhile, but for the time being parties are still working on getting the fundamentals in place.

Investing is a relatively easy — but lengthy — process

The process for investing in a city commercial bank is relatively straightforward — but it can be a very lengthy process. As a city commercial bank already has an operating license, a joint application to the CBRC for a change in shareholder structure is all that is required, but a number of factors impact just how long it can take, including:

- The application requires a reasonable amount of documentation to be provided by both parties. From the foreign investor's side, this includes demonstrating minimum total assets of USD 10 billion and a capital adequacy ratio of no less than eight percent; two consecutive years of profitability; and a good credit rating over the past two years from a recognised rating agency.
- What relationships the city commercial bank and the foreign investor have with the CBRC and at what level; for example, if the relationships with the CBRC are all at the local level, additional time may be needed for central CBRC approval.

Although the application process is straightforward, it lacks transparency — the CBRC may request additional information at any time during the process while providing little indication regarding status of the application or the expected approval date.

Foreign investments in city commercial banks

Status of foreign investment	City commercial bank	Foreign partner(s)
Approved (2001)	Nanjing City Commercial Bank	International Finance Corp. (15% - USD 27 million)
Approved (2001)	Bank of Shanghai	HSBC (8% - USD 63 million) International Finance Corp. (7%) Shanghai Commercial Bank (3% - USD 23 million)
Agreed (2003)	Dalian City Commercial Bank	Tian An China Investments (10%)
Approved (2004)	Xi'an City Commercial Bank	International Finance Corp. (2.5%) Bank of Nova Scotia (2.5%) [Initial total 5%, rising to total of 24.9% in 4 years]
Agreed (Sep. 2004)	Jinan City Commercial Bank	Commonwealth Bank of Australia (11% - USD 17 million, with an option to take up to 20%)
Agreed (Mar. 2005)	Bank of Beijing	ING (19.9% - USD 215 million) International Finance Corp. (5%)
Agreed (Apr. 2005)	Hangzhou City Commercial Bank	Commonwealth Bank of Australia (19.9% - USD 78 million)
Rumour (Nov. 2003)	Shenzhen City Commercial Bank	Bank of East Asia (15%)
Rumour (Apr. 2004)	Guangzhou City Commercial Bank	Bank of East Asia
Rumour (Aug. 2004)	Changsha City Commercial Bank	International Finance Corp. (15-19.9%)
Rumour (Oct.2004)	Wenzhou City Commercial Bank	In talks with a number of foreign banks
Rumour (2004)	Nanchong City Commercial Bank	German Investment and Development Company (DEG)
Rumour (2004)	Chengdu City Commercial Bank	PPF Group
Rumour (2004)	Dalian City Commercial Bank	In talks with a number of foreign banks
Rumour (2004)	Ningbo City Commercial Bank	In talks with a number of foreign banks
Rumour (Apr. 2005)	Harbin City Commercial Bank	International Finance Corp
Rumour (Apr. 2005)	Suzhou City Commercial Bank	In talks with a number of foreign banks

Source: KPMG analysis of media reports and press releases

Which banks are left?

With keen interest in the market, selecting one of the better remaining city commercial banks may be challenging. Making that selection can become even more problematic when little public information is available on individual banks — and financial details may not become available until due diligence begins.

There are two key stages during the selection process of a city commercial bank, before a foreign investor enters into any negotiation or due diligence process:

- Stage 1: identify which geographic location is the most attractive. An initial selection based on the size of population and economy of the city is an important first step — i.e. deciding where you want to be — as this will determine the customer base for future activities.
- Stage 2: identify which banks are more reputable. With a lack of reliable information on individual bank performance, investors are advised to initially select banks based on generally accepted industry rankings and discussions with industry insiders on their respective reputations, before they gain access to the books.

Sizeable targets are becoming scarce

As the city forms the customer base of the bank, selection based on local economy and population size is a useful screening process.

“We always selected the city first. Without a decent sized economy or population, it doesn’t matter how good the bank is.”

- A banking executive in an interview with KPMG

Out of the top 20 largest cities in China, seven have banks that have already received some level of foreign investment: however this still leaves many sizeable cities with commercial banks potentially available for investment.

Top 20 cities in China by population

City	Population 2003 (million)	GDP 2003(USD billion)	City commercial bank	Percentage of foreign ownership
Shanghai	12.8	76	Bank of Shanghai	18%
Beijing	10.2	44	Bank of Beijing	25%
Chongqing	10.1	27	Chongqing City Commercial Bank	-
Wuhan	7.8	20	Wuhan City Commercial Bank	-
Tianjin	7.6	30	Tianjin City Commercial Bank	-
Guangzhou	5.9	42	Guangzhou City Commercial Bank	-
Xi'an	5.1	11	Xi'an City Commercial Bank	5%
Nanjing	4.9	19	Nanjing City Commercial Bank	15%
Shenyang	4.9	19	Shenyang City Commercial bank	-
Shantou	4.8	6	-	-
Chengdu	4.5	23	Chengdu City Commercial Bank	-
Hangzhou	3.9	13	Hangzhou City Commercial bank	20%
Foshan	3.4	4	Foshan City Commercial Bank	-
Jinan	3.3	17	Jinan City Commercial Bank	11%
Harbin	3.2	17	Harbin City Commercial Bank	-
Changchun	3.1	16	Changchun City Commercial Bank	-
Tangshan	3.0	16	Tangshan City Commercial Bank	-
Dalian	2.7	20	Dalian City Commercial Bank	10%
Zibo	2.7	11	Zibo City Commercial Bank	-
Huaian	2.7	5	Huaian City Commercial Bank	-

Notes: Actual population of cities may be much higher depending on definition
Sources: China Population Statistics Yearbook "2003 China population ranking by cities" Dec 2003; Hong Kong Trade Development Council website, May 2005; Official websites of Chinese cities, May 2005

Ranking systems can assist in the selection process

There are only a few industry rankings of city commercial banks and most of these produce fairly similar results. Generally, the overall rating compares banks on their competitiveness based on a number of indicators.

One ranking that is commonly recognised in the industry is produced by the Banker magazine and the Rating Center of China's Commercial Banks' Competitiveness, which places Shanghai, Tianjin, Hangzhou, Beijing and Nanjing as the top five city commercial banks.

Top 20 ranked city commercial banks (rating out of 100)

	Name	Overall rating	Market share rating	Capital adequacy rating	Profitability rating	Asset quality rating
1	Bank of Shanghai	**89**	100	84	75	94
2	Tianjin City Commercial Bank	**87**	95	85	85	80
3	Hangzhou City Commercial Bank	**84**	85	84	79	88
4	Bank of Beijing	**83**	100	73	66	81
5	Nanjing City Commercial Bank	**82**	74	91	77	86
6	Shenzhen City Commercial Bank	**77**	97	59	58	88
7	Dongguan City Commercial Bank	**75**	72	77	72	80
8	Changsha City Commercial Bank	**74**	70	73	82	76
9	Xi'an City Commercial Bank	**73**	68	78	59	80
10	Hefei City Commercial Bank	**73**	52	83	80	83
11	Jinan City Commercial Bank	**73**	61	79	55	92
12	Taizhou City Commercial Bank	**72**	47	77	84	87
13	Wuxi City Commercial Bank	**70**	68	74	-	79
14	Shaoxing City Commercial Bank	**70**	47	75	72	92
15	Ningbo City Commercial Bank	**70**	76	64	-	79
16	Panzhihau City Commercial Bank	**69**	-	90	87	77
17	Dalian City Commercial Bank	**67**	80	-	77	77
18	Jiaozuo City Commercial Bank	**67**	-	100	62	74
19	Nanchong City Commercial Bank	**67**	-	89	61	87
20	Nantong City Commercial Bank	**67**	46	76	61	83

Notes: - : Not ranked within the top 50 for that criteria
Source: China Financial News Center "China city commercial banks competitiveness ranking media release" Mar 2005

So, which banks are better?

For a foreign investor, finding a city commercial bank that performs at the same level as international banks is difficult, if not impossible. Banks in China, although large, generally do not perform as well as international banks, and at some city commercial banks performance is very poor indeed.

Should this deter a foreign investor though? On the whole, it has not appeared to — but this has largely depended on how much time and effort the foreign investor is willing to spend to improve such areas as risk management and credit controls, capital adequacy and product development. An executive of an international retail bank commented to KPMG in an interview:

"You have to go in with your eyes open. These banks are not always the best — that's why they're for sale. But the question you have to ask is: can you work together to improve the situation?"

The issue many foreign investors face though is that they often cannot tell objectively which are the better performers until they begin their due diligence process. Much of the initial differentiation is based on the bank's reputation in the market place; as one KPMG banking professional commented:

"You can't say which [bank] performs better — but you can say which has a better reputation."

The CBRC is thought to have ear-marked around 30 banks as being the better performers[21], but based on reputation, many of the banking executives we spoke with identified no more than 15 city commercial banks that they would consider investing in.

This leaves a very large number of banks at the bottom of the list and a very small list of reputable banks still available.

(21) KPMG interviews with banking executives

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What issues have foreign investors faced?

It is axiomatic that no transaction in China (or any other emerging economy) is problem-free; investments in city commercial banks are no exception. How one manages these issues is what will differentiate a successful investment decision from a poor one. Better screening, a thorough consideration of the objectives of the intended investment, a detailed assessment of the intended partner and more thorough due diligence up front can help mitigate these risks.

Alongside the typical issues found with any deal in China (for example, lack of transparency, non-productive assets, bad debts and contingent liabilities), banking executives we interviewed identified three key areas that they considered closely when evaluating potential partners.

Strategic alignment

Many of the executives we interviewed agreed that not having clearly aligned strategic objectives before entering into detailed negotiations has been a significant pitfall. Although on the face of it, the objectives of each party may seem to be clear, "having them discussed and agreed up front will save everyone a lot of time" commented one interviewee. He went on to say:

"It may seem obvious, but you really need to be on the same page from the beginning."

This sentiment was echoed recently by Richard Williamson, General Manager, Business Development for Greater China of Commonwealth Bank of Australia, who in the press commented that his bank settled on Jinan City Commercial Bank because "We thought they had a very clear strategic vision."[22]

Specifically, strategic alignment in the following areas is seen as important:

- What internal issues need to be resolved within the bank
- What products the bank is looking to develop
- What niche the bank wants to create for itself in the market

One executive of an international bank commented to KPMG on his bank's deal:

"You need a lot of patience. Most banks want everything right away, but showing them a structured approach to evaluating [strategic] options helps both parties."

(22) Asian Wall Street Journal "City lenders offer foothold for international investors in fast-growing market" Feb 2005

Local government control

All city commercial banks have some level of local government influence, which in the past has often had an impact on the quality of the loan portfolio of the bank. The extent of local government influence over the operations of the bank will vary and may affect certain aspects of the bank's operations more than others.

Whether the level and nature of local government influence is a dealbreaker depends on the attitude of the bank and the foreign investor. One executive said to KPMG in an interview:

"This is only a problem if you let it become one. You need to partner with a bank which has the right attitude — [one] whose management is looking to behave commercially."

Another interviewee commented that they recognised there may be a problem of undue influence, but it was during initial negotiations that the extent of any influence was ironed out:

"Separating any government influence is not going to be possible. But, having a partner that is looking to develop and change the bank in a way that you want to, is what is important — it doesn't matter if they're government or private."

Key operating personnel

As with many investments in China, paying close attention to the details of the operational agreements goes without saying — as one KPMG banking professional commented: "With city commercial banks, the devil is in the detail."

Most interviewees agreed that placing key personnel into the positions of product development and risk management is essential. An executive of an international retail bank told KPMG in an interview:

"Having those key operational positions will help immensely with developing and improving the bank."

Another executive of an international bank agreed, commenting that most city commercial banks want assistance with product development, but if it resists the foreign party placing key personnel in the risk management role, this is a potential red flag.

"These are the areas that [city commercial] banks have experienced problems with, and where a foreign investor can bring the most value."

Although investing in these positions will require more time and effort on an ongoing basis, it is more likely to pay off; as one interviewee said:

"It allows you to feel the pulse of the organisation. This will help you understand how they think and enact change more smoothly."

"Being on the board doesn't mean you understand the operations. You need someone in there."

Executive of an international retail bank interviewed by KPMG

Building "trust" may be the key mitigant

Many of the typical issues faced by foreign investors in China can be uncovered and dealt with during the early stages of negotiation and during the due diligence process.

However, some of the issues faced by foreign investors need to be dealt with through a gradual process. In an interview with KPMG, one executive of an international bank commented:

"The investment will pay off, but you need to manage cultural change, develop a clear delegation of authority and gradually introduce changes."

Another executive explained the following key periods of transition:

1. Educational: educating the local partner on what options are available, for products or management processes;
2. Buy-in: a period where the local partner can understand and accept the rationale behind the options;
3. Settling: where the buy-in is transferred to lower levels of the organisation and does not simply remain a top management decision; and
4. Ownership: which eventually must be transferred to the local partner in its entirety for any option to be successfully implemented.

He also explained that this is a process that takes time and patience, and that looking to enact massive changes immediately would be too much of a shock for most city commercial banks.

Almost all executives KPMG interviewed agreed that establishing a basis of trust between both organisations was essential to successfully managing any issues that arise; as two executives of different banks told KPMG in interviews:

"Without that trust between us, we would not be able to achieve half of what we have. Both parties need each other — working together is the only way this [deal] will be a success and worth our investment."

"After you've built that trust you know that together you can take the bank forward."

The watchword is patience

Potential investors need to consider a few factors before plunging into the market:

- For any investment in China, the watchword is patience. A two-year due diligence and negotiation process would not be untypical, not to mention a lengthy application process and, once signed, an integration process that can be equally long.
- Foreign investors need to send their best people in early to participate in the selection, negotiation and due diligence processes — it will not work to send over the best team only after the deal is signed.
- Foreign investors also need to do their homework and should seek out professional advice throughout all stages of their investment.

CEO questions

We suggest that as a CEO looking to invest in a city commercial bank, there are a number of questions one should be asking before and during an evaluation of the market and available partners:

- What is the strategic objective of taking my bank into China?
- What alternatives do I have for entering the China banking market?
- How comfortable am I with a minority stake, given the size of the investment I am making?
- Am I ready to deal with a different management style?
- Have we clearly identified what we bring to the table in terms of products, management, systems (and even brand) and what our partner is offering?
- Do we both share a vision of what we want to achieve?
- Are we prepared to provide significant input to the development of the bank — even if it means profits are five years or more in the future and additional injection of funds may be required?

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Reprinted in March 2007