



BANKING

Incorporation and beyond

Challenges for foreign banks in China

FINANCIAL SERVICES

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Introduction

Over the past two years, 30 foreign banks have taken the step of locally incorporating their business in China. This has given them the opportunity to expand their banking operations and compete more directly with domestic Chinese banks in a number of product and service areas, including retail banking.

The unprecedented market turmoil of recent months has forced every institution to reconsider its global strategy. However, for those who still see global expansion as a priority in their strategic planning, this report provides valuable insights into the market conditions in China.

As this report describes, there have been many different motivating factors behind the decision to incorporate. In hindsight, some banks have been better prepared than others for the incorporation process, as well as the challenges that have followed.

The process of incorporating locally is costly and time-consuming. It represents a significant commitment to the China market and serves as the first step towards the creation of a larger organization, which is more independent from the group or head office.

However, it also provides a window of opportunity, for banks to address a range of issues relating to the resources and processes that they need to develop, to deliver long-term strategic growth.

Banks that allocated more resources and had more commitment from their head office have tended to navigate China's incorporation process more successfully. Those that have encountered delays or issues in the full-scope inspection process may be prone to greater scrutiny from the regulators in the future.

In many respects, a locally-incorporated bank will need to adapt its management style and culture in the new marketplace. Prior to incorporation it might have primarily served expatriate residents, foreign corporates or those domestic clients requiring foreign exchange facilities. Now it will potentially have access to many millions of customers.

The question, therefore, is how it will adapt and distinguish itself from local competitors in the wake of these changes. Essentially, it will face the same challenges of sustaining performance and high levels of service. But as the incorporated bank grows, it will be required to follow the same regulatory and tax requirements as its local peers. It will need management who can work with autonomy and with a high-level appreciation of the changing business and regulatory landscape. It is a challenge for any company looking to enter new markets.

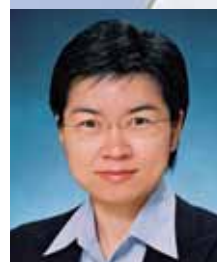
We hope you find this report insightful and we would welcome the opportunity to discuss our findings with you further. We would also like to thank the executives who feature as case studies within this report.



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The climate for foreign banks in China

Foreign banks seeking to incorporate in China are entering the market at an extremely challenging time in the country's development. Rising prices and market volatility are influencing the direction of regulatory policy and many banks are facing pressures worldwide.

With many international banks preoccupied by faltering balance sheets and an unprecedented contraction of liquidity in the banking system, it may seem an inopportune time to be expanding into a new market.

Even before the worst of the current crisis surfaced, there were cases where banks had underestimated the financial commitment involved in incorporating in China, or where they had struggled to get the necessary commitment of head office.

In the current climate, gaining those approvals and securing the necessary resources may be even more of a challenge. However many banks are still pursuing incorporation precisely as a way to sustain their growth as their existing retail and commercial banking markets weaken.

Monetary policy continues to be a key consideration for China's economic decision-makers and any regulatory issues affecting liquidity, the size of loans and the frequency of credit extension are of particular concern. As many foreign banks are taking advantage of the opportunity to incorporate by rapidly entering the Chinese market and setting out plans to expand across the country, restrictions on loan growth may not deter retail banking, but they could dramatically constrain commercial and corporate banking activities.

Leaving aside concerns over the current crisis, there are other aspects of the China market that should be addressed and anticipated. For example, while foreign banks are seen as attractive places to work, they often suffer a high staff turnover rate. Senior management staff, compliance specialists and wealth management experts in foreign banks are all highly sought-after and efforts to incorporate can be jeopardized if key management leave or additional human resources cannot be found.

This remains critical in the post-incorporation phase. From the perspective of local Chinese employees, the cultures among foreign banks are considered relatively similar and banks often recruit experienced employees from one another. As success in the banking industry ultimately comes down to talent, foreign incorporated banks should take this issue seriously as they expand.

In addition, China's new labor laws, which came into effect in January 2008, introduced changes related to the hiring, termination and compensation of employees. As a result, banks also require stronger human resources departments to manage and implement the new policies.

Status of incorporated banks, September 2008

Foreign banks obtained from the CBRC approvals on their transformation to WFOEs

Beijing

- Banque Societe Generale
- Deutsche Bank
- Hana Bank
- JP Morgan Chase Bank
- Shinhan Bank
- Woori Bank

Shanghai

- ABN Amro Bank
- Bank of East Asia
- Bank of Tokyo-Mitsubishi UFJ
- CitiBank
- Development Bank of Singapore
- Hang Seng Bank
- HSBC
- Mizuho Corporate Bank
- Nanyang Commercial Bank
- Overseas Chinese Banking Corporation
- Standard Chartered Bank
- United Overseas Bank

Shenzhen

- CITIC Ka Wah Bank
- Dah Sing Bank
- Wing Hang Bank

Foreign banks established as incorporated banks in the 1990s that have already obtained financial permits

Ningbo

- Bank International Ningbo
- Concord Bank Ltd.

Shanghai

- BNP Paribas
- First Sino Bank
- United Commercial Bank

Xiamen

- Allied Commercial Bank
- Xiamen International Bank

Shenzhen

- Chinese Mercantile Bank

Zhuhai

- Morgan Stanley

Source: CBRC website, as at September 2008

The changing regulatory environment

China joined the World Trade Organization in December 2001 and met the last of its commitments in the banking and financial services sector in 2006. One major provision was that foreign banks should be able to apply for incorporation within China. Once regulatory approvals were granted, banks could begin operating as wholly-owned foreign enterprises and could provide a full range of banking services to Chinese citizens.

As of September 2008, 30 foreign banks had gained local incorporation status. Of these, 15 were headquartered in Shanghai, six in Beijing, four in Shenzhen, two in Ningbo, two in Xiamen and one in Zhuhai. Other foreign banks are either applying, or preparing to apply, for incorporation in China.

As a result of these changes, incorporated foreign banks are now subject to the same regulation within China as domestic banks and compete directly with them in the same markets.

Regulatory requirements according to status		
	Foreign Bank Branch Office	Locally incorporated WFOE or Joint Venture
Renminbi business to Chinese Citizens	Subject to CBRC approval, cannot provide renminbi business to Chinese citizens except for acceptance of deposits in excess of RMB 1 million.	Subject to CBRC approval, can provide renminbi business to Chinese citizens.
Minimum capital	Minimum operating fund of RMB 200 million	Minimum registered capital of RMB 1 billion in freely convertible currency
Statutory reserves	Must set aside 30 percent of operating fund for statutory reserves	No requirement
Loan to deposit ratio	No restriction	Must be less than 75 percent (however, a grace period to 31 December 2011 is provided)

As a precursor to incorporation, foreign banks need to have a satisfactory international track record and evidence of continued profitability. They need to set up effective internal control policies and procedures and obtain the necessary approvals from the regulators in their home countries.

The Chinese government has been taking steps to improve financial regulation and supervision in order to maintain a safe and stable environment in which commercial banks can operate and interests of bank depositors are protected.

This system of regulation works on three levels: central bank control, governance of state-owned institutions, and governance of financial services activities. These are described below.

Under this complementary three-tier system, the PBOC has helped to create a conducive environment for drafting and executing regulations for the CBRC and the SAFE. The CBRC is the primary government agency and point of contact for commercial banks and is responsible for the supervision of commercial banking operations. The SAFE continually monitors the foreign exchange related activities of commercial banks, and aligns its policies and regulations with those implemented by the PBOC and the CBRC.

Three-tier structure

The People's Bank of China (the PBOC)

The PBOC is China's central bank and used to be responsible for supervising both the nation's monetary policy and financial institutions. The Chinese government decided to divide the responsibility for supervising the country's financial systems in order to construct a more effective supervisory system and a more independent central bank.

At present, the PBOC's duties are to draft and execute monetary policy; supervise the local inter-bank loan market, inter-bank bond market, foreign exchange market and gold market; guide and implement anti-money laundering procedures; and establish, manage, and promote a national credit system.

The China Banking Regulatory Commission (the CBRC)

Established by the State Council in 2003, the CBRC is responsible for formulating rules and regulations governing banking institutions; authorizing the establishment, changes, termination and business scope of such institutions; and conducting on-site examination and off-site surveillance of their operations. The objective is to protect the interests of depositors and maintain market confidence through prudential and effective supervision.

The State Administration of Foreign Exchange (the SAFE)

The SAFE is responsible for overseeing the financial services provided by commercial banks alongside the

central bank control and governance of state-owned institutions. The SAFE primarily supervises and manages the foreign exchange market and the operation of foreign exchange related functions, such as approving of QDII volume, approving long-term and short-term annual foreign debt volume, and supervising foreign exchange payment.

China's banking regulatory institutions strive to achieve a "One Bank, One Commission, and One Bureau" environment for wholly foreign-owned enterprise banks. The principle of joint supervision is designed to maintain the stable development of commercial banks.

Regulatory supervision

In order to harmonize the standards for foreign and local banks, and create a fair and competitive market environment, the PBOC and the CBRC have already revised their regulations several times. But while these regulators are trying to improve the focus and effectiveness of their policies, foreign banks must still abide by some additional regulations, which include local laws, department rules and regulations, operational guidance documents and notice documents. These may be issued not only by the regulatory agencies at the central level, but also by their branch offices.

Between them, China's regulators monitor five key areas: stability, independence, compliance, risk and operational management. Supervision methods differ according to the nature and requirements of different regulations but there is a broad trend towards more risk-based approaches.

To help ensure stability, many CBRC branch offices meet regularly with the board members and senior management of the locally-incorporated foreign banks. The CBRC requires the board of directors to report information from board meetings and to allow them attend when necessary. These activities improve the communication between foreign banks and regulators and are an effective way of strengthening supervision and overseeing the banks' stability.

After a foreign bank has incorporated in China, the CBRC also monitors its independence from the parent. The parent bank should provide support, but the locally incorporated entity must ensure its management operates independently.

Foreign banks must establish their own independent system to cover risk identification, risk supervision and risk evaluation. The bank must also ensure that its risk management staff have the relevant qualifications and should not rely on holding companies to take responsibility for risk management functions. Operations outsourced to holding companies should include clear contracts to identify the rights and obligations of both parties.

Banks must fulfil an increasing number of compliance and operation license management regulations in order to gain the status of a wholly-owned foreign entity. These policies allow regulators to monitor banks for money laundering activity; to examine foreign banks' scope of operations and client structure; and to regulate the reporting duty of banks' headquarters.

Under the policies for operation licence management, regulators will check that the bank has maintained adequate accounting records and that all its internal controls are effective.



What lies ahead

As China has opened up its banking system, the CBRC has sought to follow and adopt the best practices of banking supervision from developed countries. In the current global climate, banks are likely to see a trend towards more constraints rather than deregulation. The implications will be felt especially strongly by foreign banks.

On the one hand, the convergence of international rule setting has exposed the CBRC to many best practices of banking supervision in areas such as the Basel II New Capital Accord. Transparency is expected improve alongside the Chinese government's commitment to the WTO.

On the other hand, the CBRC tends to use banking regulation not only as a tool to control risks but also as a way to accommodate the state's macroeconomic policy. Thus, while areas such as foreign exchange, commercial banking and international fund transfer appear to be opening up, administration in these areas may increase, in an effort to reduce risks and facilitate economic and other government objectives. This could disproportionately affect foreign banks, which might seek to develop a competitive advantage in these areas.

In addition, unlike the direct forms of communication used with domestic banks, the CBRC may use regulatory stipulations as a way to communicate with foreign banks. This could lead to reviews of the management and operations, or involve setting up entry barriers for both banking and trading books. The CBRC also plans to issue detailed licence requirements for foreign banks.

The credit crisis lends further support to the CBRC's belief that strict supervision is needed to maintain financial stability within China. This has led to further compliance pressure on all the banks in China.

In summary, Chinese banking regulations generally appear to be moving towards or in line with international best practices. This is likely to result in greater regulatory transparency, but as elsewhere, the prospects for stricter regulations on the banking sector are likely to increase the pressure on management in terms of the cost and time involved in compliance.

Accelerated learning

Hiroshi Suzuki, Mizuho Corporate Bank (China) Ltd.

Mizuho Bank had strong support from their office for the incorporation of their head office operations in China. With that came strong expectations for subsequent growth.

The story of Mizuho Corporate Bank's growth in China is an unusual one, as it was the first bank that sought to incorporate specifically to conduct wholesale, as opposed to retail, banking services.

"After the first wave of four banks, we were one of the next in line and the first of the Japanese banks," says Hiroshi Suzuki, General Manager for Mizuho's Corporate Banking Coordination Division. "We were very enthusiastic about doing this, because we felt it would allow us to serve and respond to our corporate clients more flexibly as they grow in China."

Specifically, Suzuki-san believes that incorporation will allow it to expand more quickly. This is illustrated by the fact that it took almost ten years between the opening of Mizuho's Beijing branch and its last branch, prior to incorporation, in Wuxi. Having incorporated, Mizuho are now applying to open four new branches simultaneously.

The incorporation was also critical as a way for Mizuho to conduct more renminbi business. "For a foreign bank, once you have set up a branch office, it can still take some time to start your renminbi business," Suzuki explains. "That time lag is now much shorter."

The decision to incorporate has already yielded results, with Mizuho now employing over 1,000 staff in China, compared to 750 at the time of incorporation. Japanese or other expatriate staff account for less than 10 percent of that number.

Reflecting on the challenges of the incorporation process, Suzuki-san believes the need to formalize internal procedures and controls was a challenge both during and immediately after incorporation. He believes that the support of head office was unwavering at this time, but admits that explaining the rules of incorporation was no easy task. "Sometimes it is hard for head office to appreciate all the challenges of the China market, for example when decision making is a bit slower than it might be in Japan. But we had a team that we liaised with closely, who understood the situation."



"There was a lot of regulation to deal with," Suzuki adds, "but having incorporated relatively early we are in a position to make use of our knowledge and experience handling these regulations."

Mizuho now has a branch network of 10 branches, following openings in the northern cities of Dalian, Tianjin and Qingdao over the past year. He expects to increase the network to 12 or 13 branches in the near future, but beyond that, he is pragmatic. "Looking further ahead it really depends on the needs of our clients and where they are operating," he explains. "We currently have a good spread of branches. We serve a lot of the subsidiaries of our Japanese clients and we are also looking to serve more domestic clients as well as subsidiaries of other overseas companies."

"We have the opportunity to operate in retail banking but for now we remain committed to our corporate clients," he adds.



Risk management challenges

While foreign banks in China must demonstrate independence from their parent as part of the incorporation process, they can achieve a competitive advantage by leveraging their parent bank's resources and experience to implement leading risk management systems.

This remains true despite the recent uncertainty in the financial markets, which has narrowed many banks' options in managing liquidity and capital.

In China, banks face three particular challenges in relation to their risk management operations:

- The limited availability of experienced personnel: As risk management is a relatively new concept in China, qualified and experienced risk managers and analysts can be hard to find. Bringing in foreign expertise is one option, but banks may find it more beneficial to have predominantly local staff run and manage risk management functions in the longer term.
- Insufficient credit records for both corporate and retail customers: Banks also face problems given that customer credit records will take time to assemble. China's recently established and centralized credit bureau is still limited in its ability to supply credit information and so foreign banks face problems providing support and advice to front-line loan granting and monitoring officers.
- Localization issues related to risk management procedures and policies: Cooperation between parent and local bank is required to ensure that foreign banks achieve local compliance. Foreign banks need to adjust their own credit and operational risk frameworks, which may be compliant in their home country, to the relevant Chinese regulations. This will become more of an issue as China implements Basel II and foreign banks are required to comply with the local requirements in capital adequacy. In areas such as anti-money laundering (AML), foreign banks might assume their parent bank's policies are sufficient, but in some areas, China's restrictions and requirements may differ from their home country requirements and in some cases be more stringent.

IT challenges

At the group level, many foreign banks have set up wholly-owned subsidiaries to manage their IT systems. These subsidiaries typically have specialized teams and proven methodologies to handle the banks' IT operations. After incorporation, the subsidiary may have the chance to expand the network into China and develop new technologies to serve the banks, as well as other parties.

Some foreign banks will implement a new core banking system during the incorporation process, which is independent within the group's system. Decentralization may give the bank more flexibility in responding to local market requirements, especially in local IT system introduction and establishing interface with external parties.

As is the case in other areas, the lack of management resources is a major constraint and the cost of employing IT managers is increasing. As its business develops, a foreign bank will receive more and more pressure to adapt to the local market and local business requirements. Moving core banking systems into China will create the need to expand local IT management and recruit high-calibre staff.

Achieving this requires the cultivation of a local IT team. During the transition to incorporation status, many foreign banks have relied heavily on the parent bank to support their IT operations, for example by seconding management from overseas or sending local IT management to the parent bank. This is a short-term solution and banks need to consider establishing their own development and training programmes. At present, few banks have developed any such schemes to meet these needs.

In addition, IT management frameworks are not always implemented as expected during the localization process. Local IT management may traditionally have had limited authority and been required to focus on business support and helpdesk functions. In many cases, they continue to offer limited support improving local IT management frameworks, especially those relating to risk management.

Good IT management requires that staff can understand and react to the impact of local regulation. Developing a local IT management policy with clear standards, procedures and guidelines can help local management limit the discrepancies between the actual business operations and pre-defined processes.

Demonstrating the independence of the foreign bank from its parent presents a fundamental challenge for IT management, something that is clearly highlighted in the case studies featured in this report. From the parent bank's perspective, their role changes from that of direct management to shareholder status. As the bank becomes more autonomous, local management must plan for operating the bank more independently and assume responsibility post-incorporation. However, management is often unprepared to operate more independently and take on greater responsibilities, so although incorporation may be complete, the management style remains nearly unchanged.

Though technically incorporated as a legal entity in China, in reality many foreign banks have still not developed sufficient local controls over all aspects of their systems. Relying too heavily on the parent bank to supervise compliance can result in banks overlooking certain local compliance requirements.



Implications of the new corporate income tax regime

The process of incorporating as a wholly-owned banking subsidiary has some significant tax implications, particularly with the recent changes in China's tax regime. Under the old Foreign Enterprise Income Tax (FEIT) system, the applicable tax rate on renminbi business conducted by a foreign bank branch in China was 33 percent. From 1 January 2008, the new Corporate Income Tax (CIT) law has set a CIT rate on renminbi business of 25 percent.

The following are five issues relating to taxation that need to be addressed in light of the new CIT law.

- **Treatment on the revaluation gain/loss for monetary assets/liabilities in foreign currency:** The CIT law explicitly allows the deduction of unrealized foreign currency revaluation losses on monetary asset or liabilities. However, it stipulates that the cost basis of assets should be based on historical cost unless specifically permitted by the State Council, Ministry of Finance or State Administration of Taxation (SAT). Hence, any Mark-to-Market gains and losses (other than those based on foreign exchange) are not taxable or deductible until realized.
- **Withholding Tax (WHT) and Business Tax:** The SAT issued an internal circular in 1997 which suspended the collection of WHT

on inter- and intra-bank loan interest paid by a foreign bank to an overseas financial institution. There is a possibility that under the new CIT regime, this policy may be reversed in the future so that interest on inter-bank funding may be subject to WHT. However, the issue will require further clarification.

- **Lack of provisions under the new CIT regime in respect of bad debt:** According to tax regulations under the previous FEIT regime, the bad debt provision of a foreign invested bank is deductible provided that the bad debt provision balance lies within 3 percent of the outstanding loan balance at the year-end, excluding any inter-bank loans or secured loans. In comparison, the bad debt provision limitation of domestic bank is just 1 percent of risk assets. Under the old regime, there used to be conditions that must be met before debt could be written off for tax purposes. At publication time, the new CIT regime was still silent on the deduction limit for bad debt provisions, or the conditions for bad debt write-off, which creates uncertainties for foreign banks in China.
- **Transfer pricing on foreign banks in China:** Foreign banks and foreign bank branches face differences relating to the deductibility of head office charges. According the CIT

law, a foreign incorporated bank cannot deduct charges allocated by the head office or a related entity, whereas a branch of a foreign bank may do so. A foreign incorporated bank is allowed to deduct reasonable service fees for transactions between related parties that are conducted on an arms-length basis. The SAT is preparing new transfer pricing documentation rules and is starting to enforce transfer pricing on financial institutions.

- **Tax administration on foreign banks with branches in China:** In a recent circular, the SAT required companies with branches in multiple provinces and municipalities in China to pay provisional quarterly taxes to different tax bureaus, based on certain allocation factors. This circular has been interpreted differently between head office and branch locations since tax officials in various regions require foreign banks to file their quarterly provisional taxes differently. The inconsistent interpretation of the circular creates risks and inefficiencies that need to be managed.

The implications of the CIT are still being evaluated and some areas require further clarification. For example, it is unclear how the historical unrealized gains or losses such as on foreign currency should be treated.

Ready for a new wave of growth

Leslie Ko, BNP Paribas (China) Ltd.

Leslie Ko moved to the Shanghai office of BNP Paribas at a time when the Bank's application to incorporate was already underway. Ko oversaw the regulatory and documentation process and also wider operational and project management issues.

BNP Paribas first commenced its banking activities in China in 1860 and established a subsidiary in China in 1992 under a joint venture with ICBC. The partner was bought out in 2003 and the entity was renamed BNP Paribas (China) Ltd. As such, the French-headquartered Bank already had considerable experience in the China market, but wanted to convert to local incorporation which would also allow the Bank to obtain a full renminbi licence.

As Leslie Ko, COO and Deputy CEO explains, the decision was taken in October 2006 to locally incorporate the wholly foreign owned enterprise (WFOE) and convert the foreign bank branches in Beijing, Tianjin and Guangzhou under the umbrella of a newly incorporated entity.

Although this was after the first round of WFOE conversions had begun, that did not simplify the exercise with regards clarification of the rules and process for BNP Paribas given, as Ko states, that BNP Paribas was in a special situation. It already had a subsidiary into which

the activities were to be transferred, rather than needing to create a new entity. In addition, Ko believes that the authorities were becoming more demanding in some respects.

"The main requirement for us was to create a Board fully responsible for the activities of the subsidiary with a standalone local layer of risk management, establishing the independence of our risk management function within China," Ko explains. "BNP Paribas has globally consistent approaches to risk with various layers (local, regional and global) each performing specific roles. We had to ensure that the integrity of that management of risk was not disrupted while meeting the requirements of the CBRC for local incorporation. Globally, BNP Paribas has a stringent risk management culture which has resulted in moderate exposure in the current financial crisis and is recognized by good ratings making us today one of the three strongest banks in the world according to Standard & Poor's."

The application process was handled by the CBRC in Shanghai, and then needed to be approved by the CBRC in Beijing. After that, BNP Paribas could go through registrations with agencies such as the SAIC, the Ministry of Finance and the tax authorities. "All of these things take time and our capital increase could not take effect until the



whole process was completed," he adds.

The Bank transferred several senior people to China from other offices including Paris, to support the incorporation and the subsequent challenges of operating as an independent entity. As Ko explains, BNP Paribas' plans for China are explicitly set out in its *Ambition 2010* project. "Our head office recognizes the importance of China to BNP Paribas' global growth and that involves a significant increase in investment here. The objectives set in *Ambition 2010*, which started in 2006, were to triple our revenues by 2010 and position BNP Paribas among the top three foreign corporate and investment banks in China," he says.

"To succeed in China you need good professionals who understand the local legal, regulatory and business conditions and who can stay on top of new rules and demands," Ko adds. "You also have to maintain a close relationship with the authorities in each of your locations given the decentralized way in which many of them operate."



Opportunities for foreign banks

Foreign incorporated banks face many challenges competing with domestic banks, particularly if they are constrained in their loan growth or find it difficult to obtain approval to open new branches. Nevertheless, three strong areas of potential growth are private banking, renminbi retail banking and derivatives.

Private banking

The number of affluent households in China is increasing rapidly. In the current climate, Chinese investors may feel there are limited opportunities for them to put their cash to work. This wealthy demographic is becoming more appreciative of concepts of risk and diversification.

Compared to foreign institutions, local banks have less experience and product variety in private banking. Although a number of local banks started developing their private banking business, it will take time for them to implement the necessary operating procedures for private banking, including the infrastructure that can allow timely and effective interaction with clients.

In late 2008, the Bank of Communications established a private banking management center. Industrial and Commercial Bank of China (ICBC) started private banking business in Shanghai in March 2008. At the same time, Bank of China also announced that it will expand its private banking business to Macau. China Everbright Bank and China Minsheng Banking Corporation also launched private banking initiatives during 2008.

Industry observers have commented that many of the local banks lack a wide variety of products covering areas such as funds, trust and insurance. Also, investments through vehicles such as private equity are not well-defined or fully operational in China. As a result, local banks mostly offer standard products such as deposits, loans and intermediaries, which may not be sufficiently attuned to the needs of private banking customers.

Local banks do of course have many strengths, including their brand recognition and long-term existing relationships with VIP clients. ICBC is introducing platinum wealth management accounts, and planning to establish around 200 wealth management centers over the next three years. China Everbright Bank also plans to introduce its “platinum banking” to target customers with deposits exceeding RMB 1 million.

Renminbi retail

China is an attractive retail banking market for foreign banks due to the large number of bank accounts and bank cards held across the country. In the first quarter of 2008, the number of individual bank accounts in China rose 9.6 percent from a year earlier to more than 2.2 billion, according to a report published by the PBOC. On average, each Chinese citizen had 1.69 bank accounts.

According to the PBOC, China's total bank cards, including debit and credit cards, topped 1.58 billion by 31 March 2008, up 29.1 percent over the year. Debit cards still dominate China's bank card market, accounting for 93 percent of the market total, while the number of credit cards also doubled in the first quarter of 2008. As of March 2008, there were more than 104 million credit cards in circulation, a year-on-year increase of 92.9 percent. Bank card-based transactions accounted for 25.6 percent of the country's total retail sales, up from 21.9 percent the year before.

While the number of foreign banks' branches increased from 192 in 2003 to 440 in 2007, the geographic presence of foreign banks is still limited compared to local banks. The 'big four' banks together have more than 70,000 branches across the country. At present most foreign banks branches are only located in a handful of the major cities.

While foreign banks face some formidable competition in retail banking, there are some areas of opportunity. For example, the increasing presence of Chinese tourists in overseas destinations indicates a potential market for international financial transactions that foreign banks can help to facilitate. In 2007, 40.95 million Chinese travelled overseas, up 18.6 percent from 2006. According to the World Tourism Organization, the number of outbound travellers is expected to increase by 10 percent to 45 million in 2008 and to as much as 100 million by 2015.

Foreign banks benefit from the perception that they serve higher-end customers, and are considered more knowledgeable and experienced in the banking sector. This is demonstrated by their lower non-performing loan ratios and higher return on assets in China. However, local banks are perceived to have more local expertise, more extensive branch networks and a broader customer base.

China UnionPay, the China bankcard association, already cooperates with banks and merchants in many other countries, including most parts of South-East Asia, Japan, the United States and Europe. The 'big four' banks in China have also started to open overseas branches in key cities worldwide. For example, China Construction Bank opened branches in Singapore, Frankfurt, Johannesburg, Tokyo and Seoul, while Bank of China also has branches and offices in 27 countries.

Foreign banks can bring professionalism and experience to retail banking products in China. However their local rivals are taking steps to increase their competitiveness by training employees and raising the consistency of retail services. Many local banks are also bringing in foreign banks as strategic investors to help strengthen their governance and operations.

Derivatives

Derivatives products have been growing in China since 1997. Currently, the four big state banks are providing derivatives products along with some of their smaller peers, such as China Minsheng Banking Corporation, Bank of Communications and China Merchants Bank.

Most of the products being offered are currency derivatives and interest rate derivatives, but China is moving closer to allowing stock index futures, the most closely watched product in the derivatives arena. The trading of futures is likely to be extended to bonds, interest rate and exchange rate contracts as well as options.

The CBRC has on several occasions indicated that there is a strong need to promote the derivatives market in China. The state share reform programme gives a key boost to warrants which have seen active trading. Hybrid bonds have also played a role, helping local banks boost their capital as the banking sector opens wider to foreign competition.

In the current climate, more complex derivatives are likely to face regulatory scrutiny and the overall development of the market may proceed more slowly. The current turmoil has reaffirmed the regulators' belief that it pays to be prudent in the types of products it allows within China.

This is indeed a worry felt by foreign banks that they will be going back to basics which inevitably limit their hopes on decreasing their reliance on interest income.

Nevertheless, derivatives should continue to present opportunities for foreign banks.



Changing focus

Heetae Kim, Woori Bank (China) Ltd.

Woori Bank has grasped the opportunity to locally incorporate with plans to expand its retail banking business in China.

Woori Bank completed its incorporation process in early 2008 and now plans to increase retail banking activities as a share of its overall business. As part of this plan, the bank has launched internet banking facilities and hopes to launch a direct debit card before the end of the year, running on the China Unionpay ATM network.

“Our main target is not the most high worth individuals in China, but the next level, the rising middle classes,” says Heetae Kim, CEO and President of Woori Bank (China) Ltd. “While a lot of banks are trying to win the attention of the super rich, this segment is growing fast and is more approachable for us.”

This increasing emphasis on retail banking represents a change of direction for Woori, which previously focused on providing corporate banking services, primarily to Korean companies. As such, addressing IT and personnel issues was a particularly critical part of the incorporation process.

Kim recalls that in their initial meetings, the regulators asked many

questions on matters relating to IT and personnel. “They specifically asked about our training structures and the experience of our staff,” he says.

Moreover, Kim feels it proved quite a challenge to find the right people at the same time as handling the incorporation process and preparing for subsequent growth. “This is a common challenge in China,” he explains. “You need to keep the process moving and at the same bring people in and get them up to speed.”

Woori’s induction and training structure replicates many aspects of its training back home in Korea. In addition, the bank organizes training outside of the firm to help staff understand local culture and market conditions, and it also has exchanges with several local Chinese banks.

As a requirement of the incorporation process, Woori established its own IT servers and backup systems within China and data is shared and updated between the head office and the China entity on a daily basis. This also presented a challenge as the bank was simultaneously changing its global IT platform.

Overall Kim feels that the incorporation process has forced a change in outlook as they no longer rely on decision-making coming from their head office.



The traditional focus on Korean corporates remains important, as many of Woori’s clients have extensive and growing interests in China. However Kim now sees a far wider range of opportunities. Corporate clients may be “relatively more concentrated” in the country’s eastern provinces, but Kim believes there are good prospects for individual and retail banking throughout the country, including in more remote inland areas.

“We need to think how our clients think. We have a long history of working with Korean companies so it is easy for us to understand their business and their risks. If our clients are Chinese, we need to adapt. One example is that we have set up a dedicated loan office for our Chinese corporate clients.”

Kim feels that Woori has some strengths in that there is much in common between Korean and Chinese culture. “We have tried to portray a friendly approachable image,” he says. “But we also know there is much we can learn from Chinese banks.”

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KPMG China has over 8,500 staff, working in 12 offices; Beijing, Shenyang, Qingdao, Nanjing, Shanghai, Chengdu, Hangzhou, Fuzhou, Guangzhou, Shenzhen, Hong Kong and Macau.

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