

Foreign Banks in China

This survey focuses on the strategic and emerging issues faced by foreign banks in China.

July 2012



Growth

Foreign banks more than doubled profits in 2011 to RMB 16.73 billion

They also expect to grow revenues by 20% over the next three years

Regulation

The regulatory environment is the number one challenge for foreign banks

Shanghai as an IFC

Foreign banks say interest rate and RMB liberalisation are key to Shanghai's ambition

Talent

Despite talent challenges, foreign banks expect to recruit 20,000 more people by 2015

Foreword

Welcome to the 7th edition of our annual survey of China's foreign banking sector.

Foreign banks have so far succeeded in China but a tide of change is coming.

2011 was a year of significant growth with the foreign banks. The sector posted record profits of RMB 16.73 billion, while total assets grew 23.6 per cent to RMB 2.15 trillion. This is an impressive result despite the challenges limiting opportunities for growth. The future seems bright, with many banks predicting revenue growth of at least 20% this year and beyond.

But China's market is rebalancing, shifting away from manufacturing exports to an internal consumption focus. The government is supporting the development of new industries to create an innovation-driven economy. New opportunities will emerge but realising them will require a more focused and strategic approach.

CEOs of foreign banks continue to view the impact of regulation as their biggest challenge. Some banks view this situation as a burden, while others are proactively engaging with the Regulator.

Shanghai continues to chart a course towards becoming an International Financial Centre (IFC) by 2020. Foreign banks are supportive of Shanghai's ambition, but believe this can only be achieved through two critical components: interest rate liberalisation and Renminbi (RMB) internationalisation. Although interestingly, only 50% of respondents confirmed Shanghai's IFC ambitions had influenced their market strategy.

A lack of key talent is a perennial issue for foreign banks. It is a constraint many CEOs believe will significantly impact top line growth over the next three years. Many banks are aggressively recruiting, but this is driving up salaries. By 2015 foreign bank CEOs expect to recruit nearly 20,000 more people.

In addition to our analysis of the survey results, the report also contains perspectives from us on three key areas: future growth, Shanghai as an IFC and regulation.

We would like to thank the CEOs and Senior Executives who participated in the survey. Their time and effort made this publication possible. We would also like to thank Dr Brian Metcalfe for his research efforts and analysis.

We trust you will find this year's survey report informative and encourage you to share your feedback.



Raymond Yung

PwC China Financial Services Leader



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Survey overview

Survey background

This survey focuses on the strategic and emerging issues surrounding the expanding activities of foreign banks in China. It builds on the six previous surveys undertaken between 2005 and 2011.

The survey captures the diverse views and offer insights into this fast-changing financial services environment.

It is based on interviews with CEOs, senior executives and branch managers of 41 foreign banks in China.

The interviews were approximately one hour in length and were conducted in Beijing, Hong Kong, Shanghai and Shenzhen in April and May 2012.

The participants in alphabetical order were:

- Australia and New Zealand Banking Group (ANZ)
- Banco Santander
- Bank of America Merrill Lynch
- Bank of Montreal
- Barclays Bank
- BBVA
- BNP Paribas
- BNY Mellon
- Crédit Agricole
- Citibank
- Commerzbank
- Commonwealth Bank of Australia
- Credit Suisse
- Dah Sing Bank
- DBS Bank
- Deutsche Bank
- First Sino Bank
- Hang Seng Bank
- HSBC
- ING Bank
- Intesa Sanpaolo Bank
- JPMorgan Chase
- KBC Bank
- Mizuho Corporate Bank
- National Australia Bank
- Natixis
- Norddeutsche Landesbank
- Nordea
- OCBC Bank
- Rabobank
- Raiffeisen Bank International
- Royal Bank of Canada
- Scotiabank
- Société Générale
- Standard Chartered Bank
- The Bank of East Asia
- UBS
- VTB Bank
- Wells Fargo Bank
- Westpac Bank
- Wing Hang Bank

Key survey results

Overview

Foreign banks experienced their most profitable year in China during 2011.

Profit after tax leapt 115% to RMB 16.73 billion in 2011 up from RMB 7.78 billion in 2010.

Total assets increased by 24% to RMB 2.15 trillion at the end of 2011. Market share of the foreign banks increased to 1.93% from 1.83%.

This strong result arose despite difficulties in their home markets, a subdued outlook for the China and global economy, limiting opportunities for growth.

The 41 banks interviewed in this survey employ more than 35,000 people and expect to increase this by 56% to more than 55,000 by 2015.

Although the banks continue to cite the difficult regulatory environment, they recognise the need for financial reform and are looking to capitalise on the internationalisation of the RMB and the gradual liberalisation of interest rates.

They welcome China's commitment to building a sound, stable and efficient banking system. And as international banks believe they can make a valuable contribution as it evolves and becomes more integrated into the global financial market.

Commitment to China

Parent banks remain committed to their China operations and have increased again this year. It has now returned to the level reached in 2008.

Asian banks recorded the highest score among all the bank groups. Despite concerns about the Chinese economy there is no evidence that foreign bank head offices have moderated their interest. Indeed, 26 banks said that the agenda for China has changed positively.

Growth opportunities

Foreign banks continue to identify opportunities across the financial spectrum. The growth and dispersal of wealth means that a group of foreign banks are renewing and developing their presence in the retail sector and in wealth management.

Others have benefited from their presence in trade finance, treasury, foreign exchange, commodity financing, fixed income products, bonds etc.

The foreign banks believe that further deregulation will add impetus to their efforts to broaden and expand their activities in the Chinese financial market.

Many banks will place major emphasis on organic growth but acquisitions in different parts of the financial sector remain a key part of banks' strategies.

A wider product offering

Future RMB internationalisation and interest rate reform will open the door to a range of new opportunities for the foreign banks. They believe this will enable them to leverage their expertise in debt capital markets, structured products, interest rate and currency swaps.

Securitisation has gained increased attention but some participants believe it could still be five years in the future.

The broader distribution of wealth, the increase in the number of high networth individuals and future financial reform means that participants predict significant growth in the upper end of the retail sector.

Investment products, mortgages and private banking continue to attract attention. Some foreign banks are also expanding into consumer finance.

Important products

Participants have consistently highlighted debt capital markets as the area offering greatest future opportunity.

Structured products and interest rate and currency swaps are also critical areas for growth.

On the retail side, investment products were ranked in first place perhaps recognising the transformation that will take place if and when interest rates are finally de-regulated.

Continued growth

The foreign banks envisage continued revenue growth, most expect 20% or greater in 2012 and around three quarters of respondents expect this annual rate to continue through to 2015.

In their pursuit of growth, the banks have four targets namely, financial institutions, multinational corporations (MNCs), State Owned Enterprises (SOEs) and Privately Owned Enterprises (POEs).

Regulatory challenges

There is no evidence to suggest the regulatory burden for the foreign banks is becoming any lighter. A major concern continues to be the expansion and complexity of regulations. Each year brings new dimensions to the scope of regulation.

In this report the foreign banks have been subjected to new regulations on fee income, last year it was the "three measures one guideline".

Foreign banks also feel challenged by staged approval processes. For example the inability to seek simultaneous branch approvals or the three year wait period for the granting of a RMB license.

The participants scored a number of key regulatory restrictions that they would like to see relaxed. In order of importance the top five were bond underwriting, access to the derivatives market, capital requirements, CNAPS membership (currently closed until CNAPS II is available) and equal treatment on QDII.

Interest rate liberalisation

Most foreign banks believe that liberalisation will play to their advantage. A more open market will make them more competitive against the local banks. However, they stressed the uncertainty on timing, the extent of liberalisation (most believe it will be a stepped process) and the reaction of the big banks are yet to be determined. They believe the big banks' scale could simply overwhelm the foreign banks' response to interest rate liberalisation.

China regulators 'more supportive'

One interesting finding this year was that the participants rated the CBRC as a more supportive regulator than regulators that the foreign banks have experienced in their home markets. In the past, participants have criticised China's heavy regulatory burden and this year is no exception. However, a number of banks believe the Chinese banking regulators have been supportive over the last 12 months.

Shanghai as an IFC

The foreign banks are supportive of Shanghai's ambition to be an IFC by 2020, and believe they can make a significant contribution. But they see a number of challenges along the way such as interest rate liberalisation and RMB internationalisation.

The scope and pace of regulation will be key, but other perennial problems such as talent shortages, legal reform and the financial infrastructure will also need to be addressed.

The success of Hong Kong is also seen as a challenge to the elevation of Shanghai as an IFC. Its geographical proximity, deep financial services talent pool, well-developed industry and low taxation rates all serve as major differentiators.

Employees on the move

Foreign bank employees are moving again. In 2011, 14 banks recorded turnover levels between 20% and 40%. Projections for 2012 suggest that levels may rise even higher.

Foreign banks with a large retail presence are continually losing employees and those that have already established branch operations in secondary markets often lose staff to new foreign banks setting up their operations.

Foreign banks continue to believe that they operate as training institutes.

Salary inflation

Vulnerability to losing senior, well qualified staff means that salaries continue to escalate. Significant increases are expected in 2012.

Thirty eight banks forecast increases this year. Most expect increases in the 8% to 10% range but increases can be as high as 15% or 20%.

This pattern of year on year increases means that Shanghai and Beijing have salary levels for senior staff that match those in London, New York or Hong Kong.

Despite this, to fulfil the growth agenda there is little evidence of head offices resisting ongoing salary inflation.

Talent shortage

Limited human resources is a perennial issue for foreign banks and indeed China's financial services industry. The difficulty score for finding and keeping good personnel rose again this year following a trend that began in 2009.

As financial reforms take shape and the broader financial sector continues to grow, demand for skilled personnel will increase. This will place more pressure on salaries and benefits as the foreign banks seek to retain staff.

Twenty six banks said that talent shortages would have a significant or very significant impact on top line growth over the next three years.

Need to better adapt to the China market

Although twenty one banks said they had made major adjustments and six banks have made fundamental adaptations to the China market some contend that many senior bankers are still unable to successfully address its special needs and characteristics.

Those supporting the need for significant market adaptation argue that China is different and that you cannot simply replicate a successful entry strategy from other Asian markets such as the Philippines or Taiwan.

Competitive landscape

In 2009 the foreign banks viewed the domestic banks as their most formidable competitors. This year the foreign banks scored other foreign banks equal to the domestic banks in terms of competition, suggesting that the huge competitive surge that the domestic banks enjoyed at the time of the Stimulus Plan has now subsided.

Credit stable

While the majority of participants believe that corporate credit remains stable, 16 banks up from seven banks last year believe it is deteriorating.

Three quarters of respondents believe that consumer credit is stable. Despite the current economic uncertainty, several large retail banking participants are optimistic that consumer banking will continue to mature and that demand for personal loans, mortgages and investment products will expand.

Market share stable

Market share expanded to 1.93% in 2011 but 26 participants believe the status quo will remain in 2012.

Sustainable Economic Development Calls for a Sound Banking System, CBRC Chairman SHANG Fulin, 13th China Development Forum, 17 March, 2012

It's a great honor to attend the China Development Forum. I'd like to take this opportunity to update you on banking sector's support to the real economy and the CBRC's regulation on banking sector.

Currently, the financial market is still in turmoil with the international financial crisis and debt crisis interacted with each other. The uncertainty in the economic recovery is hovering over developed economies; and the emerging economies are confronted with pressure in economic restructuring. At this complex stage, we need to consider how to build a more stable banking system which is both safe and efficient.

Firstly, a sound banking system is instrumental to the sustainable development of the real economy.

This financial crisis once again proves that the steadiness of banking sector should be based on the sustainable development of real economy, and be committed to driving the long-term and stable economic growth. The National Conference on Financial Work earlier this year has made it clear that the priority in reforming and developing financial sector is to promote economic and social development, increasing financial support to those weak areas.

China's banking sector needs to further strengthen loan management. On the one hand, we should maintain a reasonable growth rate of credit volume, promoting balanced lending according to the law of economic development. Moreover, we must make sure that loans flow to the real economy, avoiding money speculation and excessive expansion of the virtual economy. On the other hand, we should improve credit structure, increase the financial support to key national industries and emerging strategic industries and enhance the financial services to "agriculture, farmers and rural areas" and weak areas like small and micro businesses. Besides, restrictions should be imposed on loans to highly energy consuming and highly polluting sectors with excess capacities.

In terms of "agriculture, farmers and rural areas", the CBRC will, by continuing to deepen rural credit cooperative reforms and developing new rural financial institutions, coordinate with other governmental departments concerned to offer policy support, pushing forward the "two full

coverage" of financial institutions and services in rural areas. By the end of 2011, the number of village and township banks had totaled 726, efficiently improving rural financial services in remote areas. In terms of small and micro businesses, we will effectively implement the differentiated regulatory policies on the loans to small and micro businesses, guide banks to speed up product and service innovation, strengthen the financial support to small and micro businesses and encourage banks to issue special financial bonds to small and micro businesses.

We encourage commercial banks to explore efficient mode and mechanism to support the real economy. Commercial banks are transforming their operation philosophy to a customer-oriented one. They attach more importance to financial innovation on products, service, procedure and business model, so that the increasingly diversified demands of the real economy can be fulfilled.

Secondly, a sound banking system needs regulatory standards which advance with the times.

The global financial crisis is a historic opportunity to review and restructure financial governance and regulatory framework. Due to the financial crisis, the focus of international financial regulation reforms is shifting from regulatory policy formulation to implementation and assessment of regulatory standards. China's banking sector, which is integrating into global financial market and becoming more and more internationalized, should timely introduce the latest achievements of international financial regulatory reforms, and boost the implementation of new international regulatory standards. This year, according to the core content of Basel II and Basel III, based on China's actual conditions and reality of banking sector, the CBRC will issue new regulatory standards on capital management of commercial banks and liquidity risk management.

Currently, the implementation of new capital regulatory standards is being orderly pushed forward. Earlier, we carried out QIS in the top 10 commercial banks and some medium-sized and small banks, which showed that the effect of implementing new capital regulatory standards on bank operation is controllable. At the same time, we are planning to adopt differentiated regulation on capital management, so as to help banks establish a stable, high-quality and diversified capital supplement mechanism. We should improve the banking sector's ability to develop scientifically, by means of financial innovation. The implementation of new capital regulatory standards has profound significance to the sound and scientific development of banking sector.

Meanwhile, we pay close attention to the liquidity risk of banking system, and will

carry out new regulatory standards on liquidity risk of commercial banks. We will urge commercial banks to deepen their understanding of new regulatory standards, enhance liquidity risk monitoring and strengthen stability management of banks' financing sources. We will speed up building the supporting system for liquidity management which is composed of relevant policies, procedures, technology and IT system, establishing a more efficient liquidity risk management system.

Last but not least, a sound banking system calls for comprehensive and efficient risk controls.

With the evolution of financial crisis, more instabilities and new risks appear in both domestic and global financial market. Currently, the international financial market and domestic financial market are increasingly interconnected to one another. Risk contagion became more evident across the on-balance sheet and off-balance sheet. Formal financial system and private lending market are closely related as well. Despite the rapid growth of the profitability of China's banking industry, potential risks still need high attention.

The CBRC will spare no effort to avoid systemic and regional financial risks, maintain the continuity and stability of regulatory policies, urge banking industry to take precautions to manage potential risks, improve the five-category loan classification standards, and fully carry out the regulatory requirements of risk management. The CBRC will enhance risk warning and promote the construction of risk monitor information system, so that systemic and regional financial risks can be identified and addressed at an early date.

Meanwhile, we will encourage banking institutions to build up the foundation of risk management, cultivate sound risk culture and awareness, construct steady risk appetite framework, and establish an overall risk management concept. In the meantime, we will help banking institutions to improve corporate governance, strengthen internal controls, and improve the forward-looking and effectiveness of risk management by applying tools like stress testing etc.

Dear guests and friends, we will commit ourselves to balancing between defending risk and promoting development, combine overseas experience with China's reality, and enhance internal management of banks while strengthening external supervision, so as to establish a sound banking system and achieve scientific development of banking sector.

PwC banking perspectives

Future growth for China's foreign banks

China's economic strength of the past year led foreign banks to enjoy a period of significant success. But how prepared are they to capitalise on future opportunities as China's economic development and financial reforms gather pace?

Foreign banks continue to grow, with total assets increasing 24% to RMB 2.15 trillion last year. Robust conditions in corporate lending helped the banks more than double net profits from RMB 7.78 billion in 2010 to RMB 16.73 billion in 2011 – an exceptional performance from the sector.

For China's domestic banks it was a different story, which largely benefitted from strong demand for credit arising from government stimulus measures, particularly major infrastructure developments.

Pathways to growth

Loan caps imposed by regulators and relatively slow branch approvals are limiting the growth options for foreign banks. To overcome these challenges, they are continuing to explore new channels and customer segments by recruiting local, experienced relationship managers to target State Owned Enterprise (SOE) and Private Owned Enterprise (POE) customers. A substantially bigger workforce will help foreign banks achieve this growth, with the 41 banks surveyed predicting they will hire nearly 20,000 new employees by 2015.

In addition to loan and deposit services, foreign banks can provide further offerings such as trade finance and cash management services. Many of these firms are expanding offshore and are keen to capture a share of the accelerating trade flows across emerging markets such as Asia and South America. Foreign banks are well positioned to assist these firms with established global networks and trading expertise.

Access to funding remains a key challenge for foreign banks, with their lending activities heavily dependent on deposits. Foreign banks hope to increase the scale of lending activities by growing their corporate deposit book. By 2015, foreign banks predict both a diminished reliance on their parent company for funding and a greater proportion of corporate deposits to finance their activities.

Another major source of potential income lies in developing financial institution (FI) businesses such as treasury products and bond trading. Foreign bank CEOs ranked regulatory approval to underwrite bonds as the most important driver for future growth. However, access to this market is limited with only a handful of foreign firms receiving approval to issue bonds.

Foreign banks are also focused on keeping pace with the expansion plans of multinational corporations (MNCs) based in China. Many are shifting their operations away from manufacturing exports towards production, distribution and marketing products for the local market. The Chinese government's efforts to rebalance the economy towards domestic consumption are driving this realignment as outlined in its 12th five year plan.

Bonds were ranked the top product for future growth potential by CEOs.

China's build-up of innovation-focused industries creates new opportunities for foreign banks.

Foreign banks will have more opportunities to diversify and differentiate themselves among certain market sectors as they mature. The 12th five year plan outlines several Strategic Emerging Industries: biotechnology, new energy, high-end manufacturing, energy conservation, and next-generation IT. These industries have been singled out by the government to be the pillars of China's next-generation, innovation-driven economy. The expertise of foreign banks in developing these industries in other markets may provide them with a distinctive advantage over their local counterparts. But this will require significant focus, planning and commitment of resources to capitalise on this opportunity.

China's build-up of innovation-focused industries is creating new opportunities for foreign banks. Foreign firms are increasingly acquiring or partnering with local companies seeking to develop new technologies and build R&D capabilities. They are seeking financiers with expertise in these industries and can provide solutions in term of cash management, investment and financing activities.

Global trade settlement in RMB

The ongoing euro zone crisis and subdued state of the US economy continues to speed the pace of RMB internationalisation. Pressure on the Euro and Greenback is driving greater use of RMB to settle trade arrangements. This is further bolstered by China signing multiple currency swap agreements with many of its key trade partners in major developed and emerging markets.

Foreign banks, particularly those with cross-border trade settlement and cash management capabilities in place stand to benefit in the longer term. As the US and Europe begin to recover, their priority will be on moderate and sustainable growth, with trade and settlements in RMB being more commonplace.

The development of the RMB is also being enhanced by the growth of cross-border RMB trade through Hong Kong. This will create arbitrage opportunities in both interest rate and currency trading activities, particularly among Chinese import and export companies. Offshore RMB debt and investment markets will further develop as trade volumes grow.

Foreign banks are establishing China desks, manned by locally trained relationship managers to capture the trade flows associated with the offshore expansion of Chinese SOEs and POEs. Although the revenue generated from cross-border activities are yet to be reflected in local books, this will eventually contribute to the success of the foreign banks in China.

Macro policy and financial reforms gather pace

The pace of financial reform has gained pace over the past six months with several major policy announcements. During this time, foreign debt quotas were increased, and interest and exchange rate bands widened. Furthermore, China's credit asset securitisation pilot program was expanded, QFII scheme entry requirements relaxed, and equity investment holdings for foreign companies have been loosened. Other programmes such as the Wenzhou pilot scheme will allow mainland residents to invest directly overseas and help widen China's capital account. These continuous financial reforms will provide opportunities for foreign banks to leverage their global networks and risk management expertise to create a competitive advantage. While we cannot predict how quickly reforms will continue, the moderate pace of the program so far should provide foreign banks with distinctive windows of opportunity.

Transforming for the future

Foreign banks must continue to learn and adapt to the local operating environment if they are to succeed long-term in the China market. Some have been responsive to the changes in the macro and regulatory environment, to date. But are they properly equipped to adopt a more proactive approach and, indeed, grow beyond their expectations?

There are certainly prospects to do so. As financial reforms gather pace, opportunities will emerge for foreign banks to capitalise on their global scale and expertise. Additionally, China's five year plan outlines fresh opportunities to diversify and grow. New pathways for growth are continuing to emerge, but will ultimately require a renewed strategic focus by the foreign banks.

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Shanghai as an International Financial Centre

As Shanghai's transformation into an IFC gathers pace, foreign banks stand to significantly benefit. But how will they contribute?

Shanghai today

Shanghai's ongoing development as a commercial, industrial and financial hub provides a compelling growth story. Last year, GDP grew 8.2 per cent and attracted US\$437 billion in foreign trade flows. Financial institutions are strongly represented in the harbor city with 1,048 entities including 173 foreign firms. Total assets of banking institutions in Shanghai at 31 December 2011 reached RMB 8.2 trillion, of which foreign banks account for around 12%.

Shanghai's role as the engine-room of the nation's financial system is reflected by the presence of key institutions: China's equity, foreign currency, future and gold exchanges. Shanghai is also host to China's domestic inter-bank and bond markets.

The IFC journey

In 2009, China's State Council announced plans to develop Shanghai into an IFC. This goal was designed to match its desire to internationalise the RMB by 2020.

In February 2012, the National Development and Reform Committee and Shanghai Municipal government jointly released the "Detailed Plan to develop Shanghai as an IFC during China's Twelfth Five-Year period" ("the Plan"). The Plan sets-out a roadmap for bolstering Shanghai's financial services capabilities. This includes establishing Shanghai as a global RMB innovation, trading, pricing and clearing centre by 2015.

Key structural reforms in the plan include significantly increasing the volume and scale of financial markets, growing the number of overseas investors, and increasing market share of foreign financial institutions, and establishing SHIBOR as the main benchmark for pricing RMB assets. Expanding direct financing and asset management services is another priority with Shanghai aiming to becoming a top 5 global derivative trading centre by volume by 2015.

To enhance market efficiency and liquidity Shanghai also introduced a centralised clearing house system in December 2011. As of May 2012, this platform supports 581 OTC financial products traded through 2,266 institutional investors.

A major opportunity

Shanghai's transformation clearly offers significant opportunities for foreign banks and their market presence suggests this. In 2011, foreign banks held a 12% share of Shanghai's banking market, compared with 1.93% nationally. Several banks have relocated key functions such as central treasury as well as head offices to Shanghai. Of China's 37 locally incorporated foreign banks, 21 are head quartered in Shanghai.

The foreign banks surveyed identified several opportunities to grow including traditional trade finance, proprietary trading and treasury businesses. Expansion by Chinese companies into offshore markets will prompt wider use of RMB in international settlements. This will create opportunities for foreign banks to facilitate cross border activities for their customers and have access to China's SOEs.

For larger foreign banks, new product development and enhancing risk management functions will feature heavily in their growth plans as China's market continues to open.

Additionally, a number of foreign banks surveyed are planning to launch new derivative products such as credit default swaps and RMB options in China. Others are targeting key industries supported by Shanghai's 5-year plan namely shipping, aircraft and infrastructure through structured financing offerings.

Financial reform is gathering pace with several major policy announcements over the past six months.

Contribution of foreign banks

Foreign banks have also contributed to Shanghai's development and will continue to do so. Many have imported commercial and capital market expertise, and provided capital injections to grow local businesses. ANZ, DBS, and JP Morgan recently announced investments of around RMB 6.7 billion to further boost their China operations in 2012.

Foreign banks have also provided risk management and corporate governance experience that will help strengthen local regulatory frameworks. Training and professional development programmes offered by foreign banks has deepened Shanghai's banking talent pool.

Some banks prepared

With Shanghai's many positives, how well are foreign banks positioned to capitalise on the many opportunities? The response has been mixed, with less than half of the banks stating that Shanghai's transformation has influenced their strategic planning. The importance of market preparedness cannot be understated.

Barriers to transformation

Despite Shanghai's many positives, foreign banks feel there are a number of obstacles that must be overcome before it can achieve IFC status. Interest rate liberalisation and RMB internationalisation were ranked by foreign banks as the top-two reforms that needed to occur. On a scale of one to 10, foreign banks scored these issues as 8.8 and 9.3 respectively.

Addressing core issues

To become an international RMB settlement centre, a robust IT system is required to facilitate efficient and accurate clearing between global financial institutions. The development of China's National Advanced Payment System will deliver a world-class currency trading platform.

Greater access to RMB funds is also needed. But this is progressively occurring through markets such as Hong Kong. Foreign funds are now able to access RMB through investment vehicles such as QFII and the proposed QDLP. Similarly, Yuan denominated 'Dim Sum' bonds provide another popular avenue with sales volumes having risen 187% over the past 12 months. RMB is now the third most traded currency in Hong Kong.

In April 2012, the central bank released new rules widening the daily exchange rate spread between RMB and USD from 0.5% to 1%, marking a significant milestone in the deregulation of the RMB.

The People's Bank of China recently announced rules giving banks greater flexibility in setting lending and deposit rates, suggesting growing momentum for interest rate liberalisation.

Interest rate liberalisation and RMB internationalisation were seen as critical to Shanghai becoming an IFC.

Lessons from aboard

Based on the experiences of Hong Kong and Singapore, significant work is also needed to reduce the complexity and strengthen existing legal and regulatory frameworks. Market deregulation is also needed to drive greater product innovation and foster more robust market competition. For example, only a handful of foreign banks have been granted approval to underwrite bonds for their customers.

Intense competition for talent globally poses issues for Shanghai attracting top talent in terms of bankers, lawyers, accountants, actuaries, financial advisers and other professions – both local and foreign. Part of Shanghai's 2020 vision involves growing its pool of financial services professionals from nearly 245,000 to 320,000 by 2015.

However, a review of Shanghai's income tax system and immigration policies, combined with incentives for foreign professionals in housing, education and health services may help it achieve this goal.

Foreign banks surveyed have expressed concerns about the central administration's ability to drive the reforms necessary to improving Shanghai's competitiveness. However, recent policy announcements demonstrate the Government's commitment to not only addressing these issues but on fulfilling its ambitions for Shanghai.

A bigger picture

With the spotlight being cast on Shanghai, is there a wider opportunity being overlooked? An announcement at the 2012 National Financial Work Conference in Beijing presents another view. The enormous size of China's economy will require the services of other financial hubs including Shenzhen, and of course Hong Kong to work in conjunction with Shanghai. The central administration will be key in developing the capabilities of these cities and determining the future role they will play. For instance, Hong Kong will continue to play an important role as an offshore RMB clearing centre with Shanghai playing a similar role for China's domestic market.

But the question remains, can Shanghai realise its ambition? As one foreign banker surveyed commented "becoming an IFC is 'not a destination but a journey'".

And it is a journey marked by significant achievements. Government reform lays the foundation for a stronger and more capable financial services industry. China's ongoing growth makes it an extremely attractive destination for foreign investment. And Shanghai will continue to evolve as both a destination for global capital and an international city. These factors present foreign banks with an opportunity to help shape what Shanghai as an IFC could be in 2020 and beyond.

“Shanghai becoming an IFC is a journey not a destination...”

The many dimensions of regulation

The impact of regulation remains the primary concern and challenge for foreign banks operating in China. But why is this so? Foreign banks have indicated numerous reasons including lengthy product licensing approvals, documentation and reporting requirements, as well as localised versions of global regulation. But is this any different to their home markets?

Regulator engagement

Understanding and responding to the needs of the Chinese banking and markets regulators is, and will continue to be, a critical success factor for foreign banks in China. It is increasingly clear that a number of institutions are benefiting from significant efforts and investments in this area. Long-term, we believe banks that view and engage with regulators like any key client relationship will be more competitive. However, accessing appropriate skills in compliance such as regulatory engagement specialists continues to be a significant issue for foreign banks operating in China.

Balancing host with home

International banking groups are experiencing an unprecedented period of legal and regulatory change, globally. The scope of reforms is affecting many aspects of banks' operating models, creating operational challenges around capital, liquidity, organisational strategy, governance structures and operating models. For foreign banks with subsidiaries in China, this adds further complexity around compliance with domestic legal and regulatory requirements while operating in the context of a broader institutional strategy. We believe the differing needs of 'Home' and 'Host' regulators will be increasingly difficult for multi-national institutions with few easy answers. The fundamental challenge for the foreign banks operating in China over the next three years will be how to balance the investment and sophistication needs of a high-growth and dynamic market against the significant regulatory and profitability constraints of their 'Home' businesses.

Opportunity from global reform

The bulk of regulatory change is being driven by both US and European regulators, using a range of legal and regulatory mechanisms, with Asia largely being a receiver of global regulation. This will create timing and interpretation issues, as Asian regulators come to terms with a plethora of complex regulatory changes, for example, extra-territoriality under Dodd Frank, Basel III and Recovery and Resolution Planning. But these and other complex regulatory changes will also create opportunities for institutions that most effectively navigate these issues, particularly around the development of their Asian client and booking strategies. It could also see business with Asian counter-parties increasingly conducted wholly in Asia.

Adapting Basel III

Foreign banks in China are generally viewing the adoption of Basel III as a positive. Its introduction will enhance data quality and governance frameworks, with many believing this will create a more competitive environment. However, the implementation of Basel II, 2.5 and III will create onshore infrastructure and capability challenges for foreign banks that currently manage their credit and market risk frameworks using offshore and regional models. We believe 'onshore light' models are no longer sustainable for Foreign Banks intent on developing a material position in the Chinese banking market, or around the liberalisation of the RMB.

Structural changes to the regulatory environment are occurring at a time of relatively weak economic growth and constrained credit conditions in domestic markets for foreign banks. We anticipate this to continue through 2012, particularly for the major European economies which combined with potential exposures to sovereign debt represents a major drag on investment in the sector.

Regulatory change in China

The CBRC has formulated and revised a set of regulatory guidelines during the past 12 months with respect to capital management, liquidity risk management, corporate governance, assessment and supervision of systemically important commercial banks. These rules apply to foreign banks as well as domestic ones. The changes, with transitional mechanisms, were introduced to strengthen risk management across the sector. However, a number of surveyed banks continue to suggest there are material legal and regulatory burdens to the development of their businesses.

In addition to the above changes, CBRC requires banking institutions to exercise greater control in setting fees and managing their operations with a view to safeguarding depositors and consumers' rights and improving customer satisfaction. These changes aim to improve the stability and robustness of the China banking industry and in a number of areas move towards greater policy harmonisation with the rest of the world such as capital and liquidity.

These changes emphasise that foreign banks must continue focusing on regulatory complexity in China despite continued moves to liberalise capital markets activities.

Survey findings

Market environment

Total number of foreign bank institutions in China in 2011

At the end of 2011, the foreign bank presence in China included 181 banks from 45 countries and regions.

This included 37 locally incorporated banks (from 14 countries and regions). CBRC statistics below show that they operated 245 branches. In addition, there were two Sino-foreign joint venture banks (maintaining seven branches and one subsidiary), one wholly foreign-owned finance company, and 94 foreign bank branches established by 77 banks from 26 countries and regions.

Foreign banks also operated 209 representative offices in China.

Foreign banking establishments in China in 2011

	Foreign banks	Wholly foreign-owned banks	Joint-venture banks	Wholly foreign-owned finance companies	Total
Locally incorporated institutions (LII)		37	2	1	40
LII Branches and subsidiaries		245	8		253
Foreign bank branches	94				94
Total	94	282	10	1	387

Source: CBRC Annual Report 2011

Foreign bank operations in China (2004 to 2011)

Item/Year	2004	2005	2006	2007	2008	2009	2010	2011
Number of institutions*	188	207	224	274	311	338	360	387
Assets**	5,823	7,155	9,279	12,525	13,448	13,492	17,423	21,535
As % of the total banking assets in China	1.84	1.91	2.11	2.38	2.16	1.71	1.83	1.93

*Including headquarters, branches and subsidiaries

**RMB 100 million

Source: CBRC Annual Report 2011

Geographic spread of the foreign banks

According to the CBRC 2011 Annual Report, foreign banks have presence in 50 cities across 27 provinces. That is 30 cities more than the number at the beginning of 2003.

Furthermore, six locally incorporated foreign bank branches have set up sub-branches in areas where export-oriented enterprises are concentrated.

Growth in total assets of all foreign banks in China (2003 to 2011)

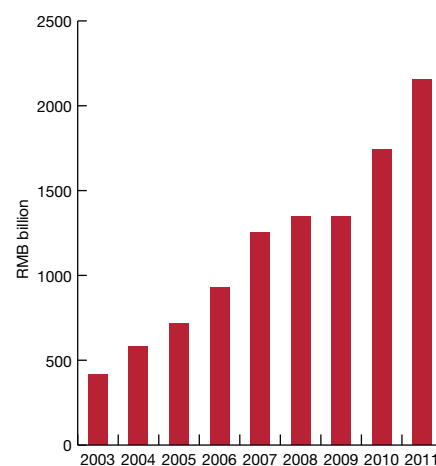
According to CBRC, at the end of 2011, the total assets of foreign banking institutions in China has increased by 23.6% year-on-year to RMB 2.15 trillion.

Foreign bank deposits totalled RMB 1.32 trillion, up by 25.27% year-on-year while loans rose 7.1% to RMB 978.5 billion.

The liquidity ratio stood at 69.53% and the non-performing loan (NPL) ratio was 0.4%.

The capital adequacy ratio (CAR) and core CAR of locally incorporated foreign banks was 18.83%.

Total assets of all foreign banks in China (2003 to 2011)



Source: CBRC

Performance of all foreign banks in China (2007 to 2011)

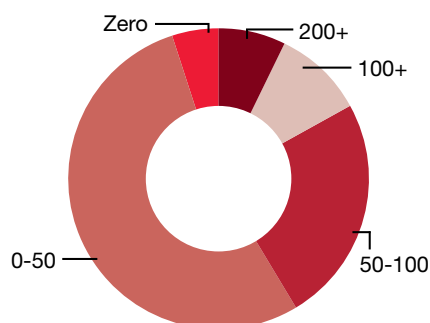
After-tax profits of foreign banks in China increased to RMB 16.73 billion in 2011, more than double that of RMB 7.78 billion the previous year.

Profits after tax (RMB billion)	2007	2008	2009	2010	2011
Banking institutions	446.73	583.36	668.42	899.09	1,251.87
Policy banks & the China Development Bank (CDB)	48.93	22.98	35.25	41.52	53.67
Large commercial banks	246.60	354.22	400.12	515.12	664.66
Joint-stock commercial banks	56.44	84.14	92.5	135.80	200.50
City commercial banks	24.81	40.79	49.65	76.98	108.09
Rural commercial banks	4.28	7.32	14.9	27.99	51.22
Rural cooperative banks	5.45	10.36	13.49	17.9	18.19
Urban credit cooperatives	0.77	0.62	0.19	0.01	0.02
Rural credit cooperatives	19.34	21.91	22.79	23.29	53.12
Non-bank financial institutions	33.38	28.45	29.87	40.8	59.88
Foreign banks	6.08	11.92	6.45	7.78	16.73
New-type rural financial institutions & postal savings banks	0.65	0.65	3.22	11.9	25.79

Source: CBRC

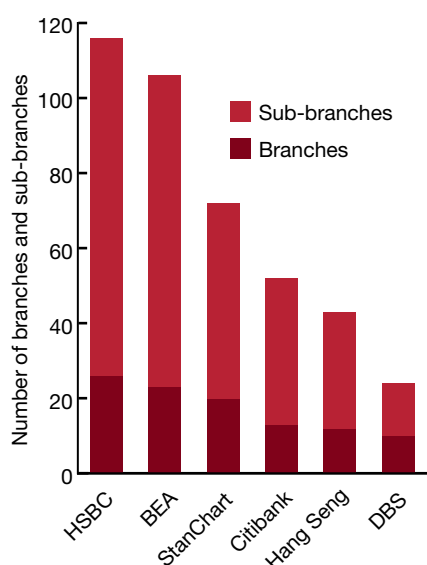
Background statistics

Projected employment increases by 2015



Based on responses from 41 foreign banks

Big Six Foreign Banks' branch network 2012



Source: Bank websites

Future employment growth

In 2012, the 41 foreign banks interviewed employ 35,408 people. In last year's study of 42 banks, the total was 34,166.

The 41 foreign banks interviewed this year forecast that employment will increase 56% to 55,104 by 2015. The Big Six banks, Bank of East Asia (BEA), Citibank, DBS, Hang Seng, HSBC and Standard Chartered Bank, together hire over 26,000 employees. Together these banks predict that by 2015, collectively they will employ over 41,000 people.

Non-PRC employees

These Big Six banks currently employ 1,397 staff from overseas. This figure will decline to 1,355 by 2015. Twenty banks said they did not forecast an increase in overseas employees and three banks project a decline.

Retail customers

Two of the Big Six retail banks declined to provide estimates of their retail customers in 2015. However, based on the estimates of four retail customers of the Big Six banks this year, and all six banks last year, the Big Six may have around 1,250,000 this year.

Branch networks

According to the Big Six retail banks websites in June 2012 they operated 413 branches and sub branches in China. However our interview research indicates that this has reached 442 branches and sub branches.

The largest network was operated by HSBC followed closely by Bank of East Asia. For details of branch and sub branch cities in 2012 see the appendix.

Cost-to-income

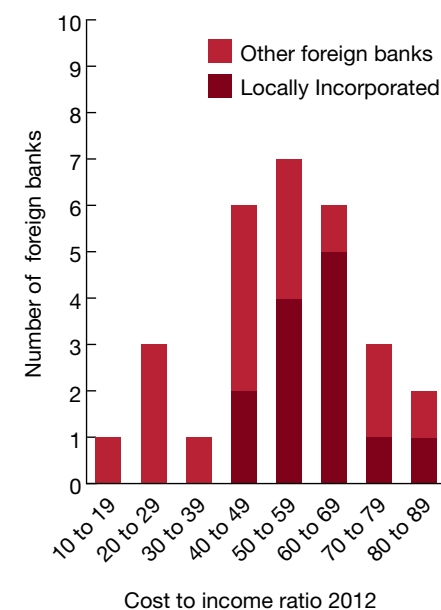
Twenty nine participants provided cost to income ratio figures for 2012 and 27 of these banks provided an estimate for the ratio in 2015. The ratio ranged from 11% to 86%.

The former bank estimates that its ratio will increase to 15% by 2015 while the latter believes it will decline to 65%

Eleven banks have ratios below 50% and 13 banks are between 50% and 70%. Two banks have ratios in the 80% range. Twelve banks forecast declines in their ratio by 2015 and five banks expect them to increase. None of the participants expect their cost to income ratio to be above 70% in 2015.

The foreign banks are in the market development stage and continue to add new personnel and open new branches. They are yet to benefit from increases in operational efficiency and economies of scale. Future improvements in the cost to income ratio are therefore likely to derive from income growth rather than lower costs.

Cost-to-income ratio 2012



Based on responses from 29 banks

Q What are the major drivers of change in the Chinese banking industry today? Please rank the top five drivers in order of importance.

Two new drivers of change were introduced in this survey – RMB internationalisation and interest rate liberalisation.

They were placed in second and third positions but failed to unseat the driver that has remained consistently in first place since 2009 – regulatory changes.

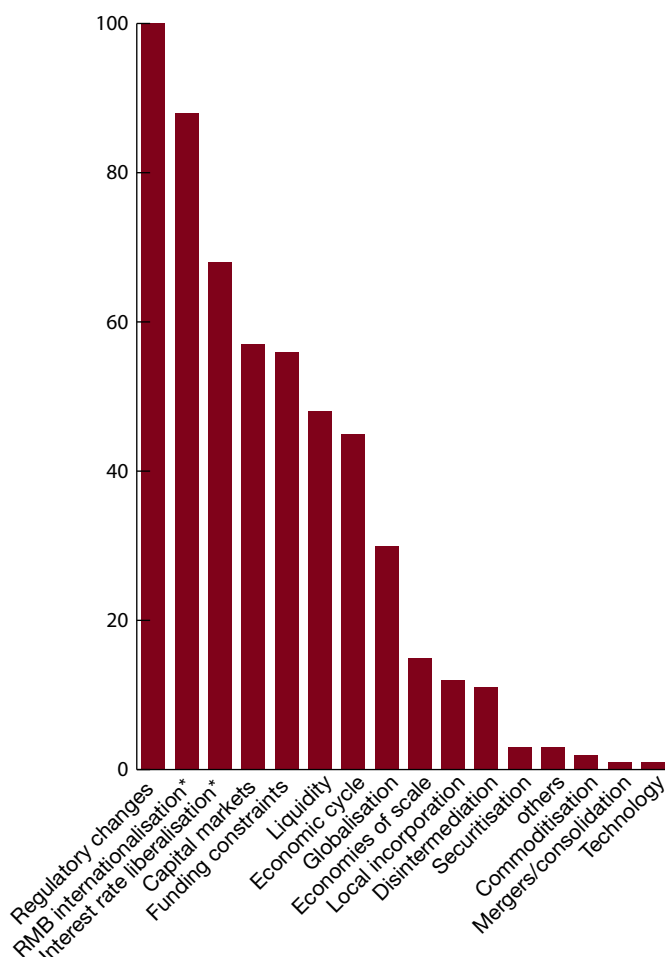
Despite the events that have occurred in the global financial markets since 2008, foreign banks continue to view the nature and implementation pace of regulatory policies in China as the most important driver of change.

In 2011, funding constraints, liquidity and capital markets took places respectively the second, third and fourth. This year, these factors are in the fourth (capital markets), fifth (funding constraints) and sixth places (liquidity).

In 2011, the economic cycle was in the sixth place and this year it came in the seventh. In the course of the survey, a number of participants made reference to the fragile Chinese economy. However this, the position suggests that it should not be considered as a key driver of change in the banking industry.

Last year's report noted the cautious optimism surrounding the opening up of the capital market. The internationalisation of RMB and liberalisation of interest rates are key drivers in the expansion of these markets.

Drivers of change



Based on responses from 36 banks
* New factor in 2012

Q What does your bank find the most/least difficult aspects of the Chinese banking industry?

The most difficult aspects of the Chinese banking industry for foreign banks are:

- the regulatory environment
- finding and retaining good personnel, and
- the ability to introduce innovative products and services to the market.

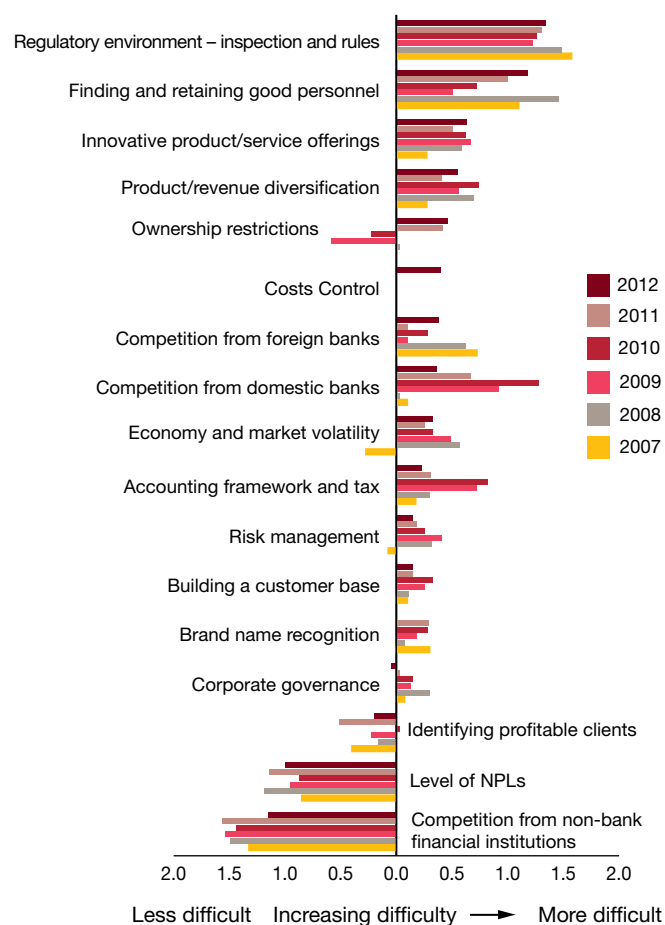
The third factor has replaced competition from domestic banks which slipped to the eighth position in 2012. This reflects the change in market dynamics following the Stimulus Plan period.

The foreign banks continue to be concerned by the restrictions placed on the introduction of innovative products. Allied to this factor is product and revenue diversification.

Ownership limitations which relate to the 20% ownership cap on up to two local banks alongside with restrictions on other financial institutions came in the fifth. This factor also relates to their ability to diversify as the financial environment becomes more sophisticated.

Costs control was introduced into the survey question for the first time this year and is placed in the sixth position, ahead of competition from other foreign banks.

Most and least difficult aspects of the Chinese banking industry



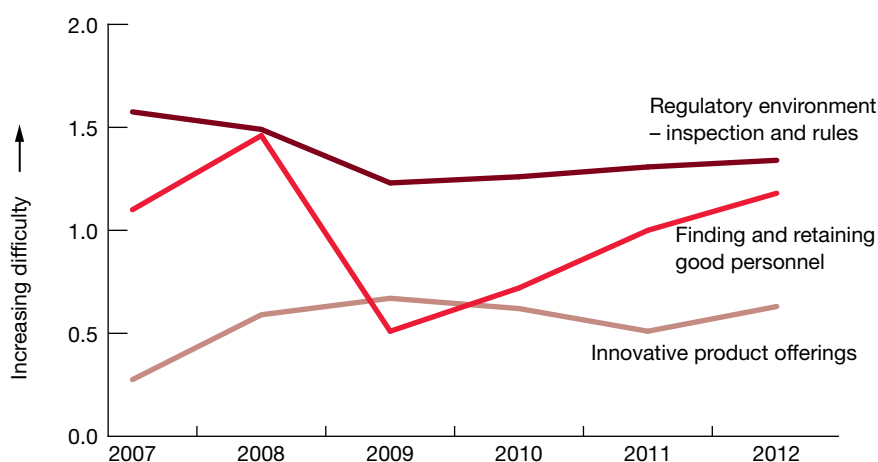
Based on responses from 40 banks in 2012

Top three most difficult aspects of the Chinese banking industry (2007 to 2012)

As noted on the previous page, innovative product offerings replaced domestic bank competition to come in among the top three over the last six years. All the top three factors recorded higher scores in 2011 and again in 2012. The increase in the difficulty of

finding and keeping good personnel showed a precipitous decline from 2008 to 2009. Since then, the rise has climbed steadily to above 2007 levels but below the peak reached in 2008. The regulatory environment has become more challenging since 2009.

Top three most difficult aspects



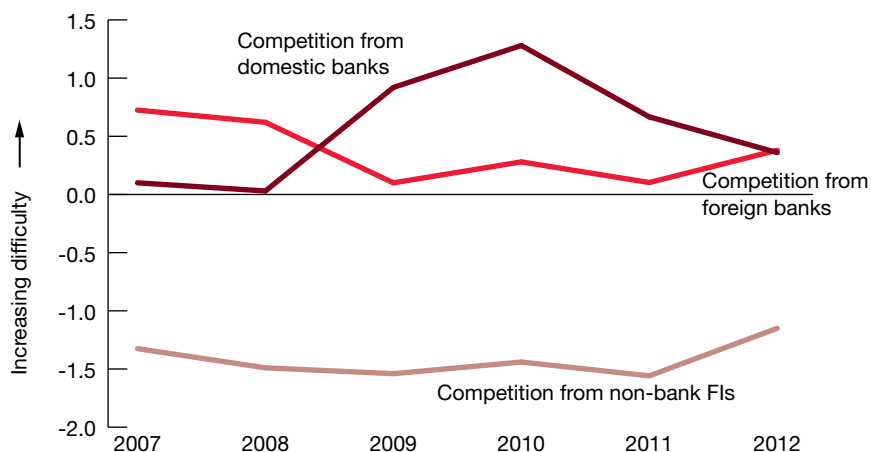
Based on responses from 40 banks in 2012

Competition between banks (2007 to 2012)

Foreign bank competition converged with domestic bank competition this year. Competition from domestic banks increased in 2009 and 2010 as the Stimulus Plan impacted the market but declined in 2011 and 2012.

This year both the foreign and domestic banks shared similar scores of 3.38 and 3.36 respectively on a scale of 1 to 5, where 5 is most difficult.

Foreign bank view of competition



Based on responses from 40 banks in 2012

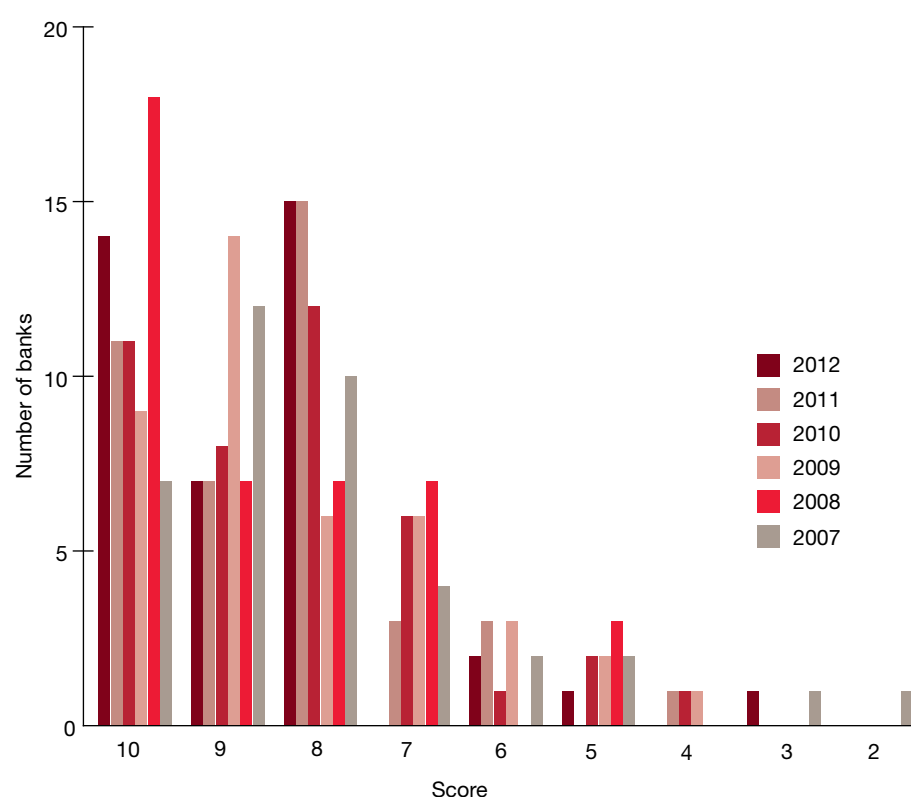
Q What is the level of commitment of your head office to China in 2012 relative to other markets on a scale of one to 10? A score of 10 is maximum commitment.

The overall average score of 8.6 for 40 banks in this survey indicates that the supporting is now at its highest level since 2008.

Scores of all regional groups rose.

Asian banks rate the commitment of their head offices to China at 9.4, the most among all regional groups. Locally incorporated lenders give theirs a score of 9.3. Fourteen banks say they are fully committed to China in 2012.

Head office's commitment to China



Based on responses from 40 banks in 2012, 40 banks in 2011, 41 banks each in 2010 and 2009, 42 banks in 2008 and 39 banks in 2007

Commitment of parent	2012	2011	2010	2009	2008
Locally incorporated banks	9.3 (17)	8.8 (19)	9.05 (20)	8.7 (20)	9.47 (16)
European banks	8.3(21)	8.2 (21)	7.7 (21)	7.8 (19)	8.3 (20)
North American banks	8.25(8)	8.0 (8)	9.0 (8)	8.6 (8)	8.6 (9)
US banks	9.0(5)	8.4 (5)	9.2 (5)	9.0 (5)	N/A
Asian banks	9.4(11)	9.1 (11)	8.8 (12)	9.0 (13)	9.23 (13)
Average	8.6(40)	8.4 (40)	8.3 (41)	8.4 (40)	8.64 (42)

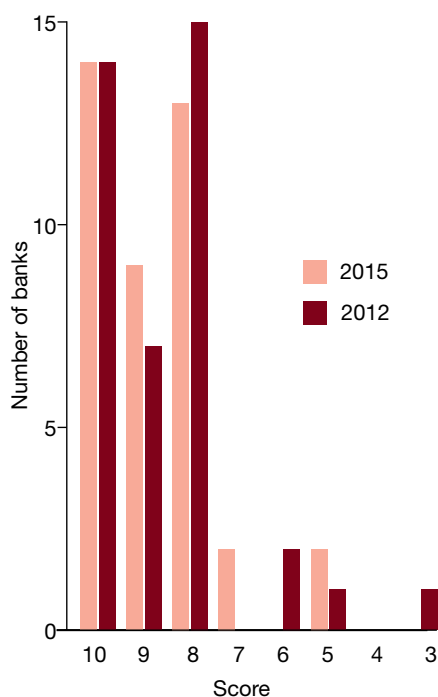
Q How would you characterise the commitment of your parent bank to the Chinese market in 2015 versus 2012?

The participants predicted an increase in commitment scores between 2012 and 2015.

Although 14 banks again projected scores of 10 in 2015, two more banks were added to the 9 out of 10 group for 2015.

The foreign bank that scored just 3 out of 10 in 2012 predicted an increase to 5 out of 10 by 2015.

Head office commitment to China going forward



Based on responses from 40 banks each for 2012 and 2015

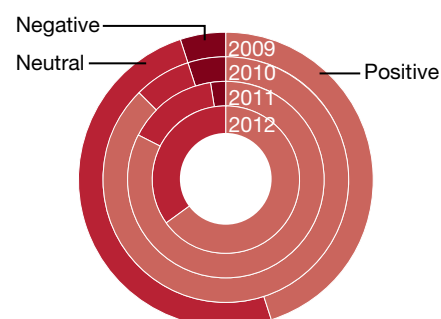
Q From the perspective of your head office, has the agenda for your bank's China operations over the last year changed? Were the changes positive, negative or neutral?

In 2012, 26 of the 40 respondents said that from a head office perspective, the agenda has changed positively over the last year. The remaining 14 banks maintained a neutral stance, suggesting that their head office held the same opinion as last year.

None of the respondents believed that sentiment towards the China market had changed negatively.

The adjacent chart suggests that head offices' views on China were least positive in 2009 but have improved over the last three years. Opinions began to trend more positively in 2010.

The China agenda



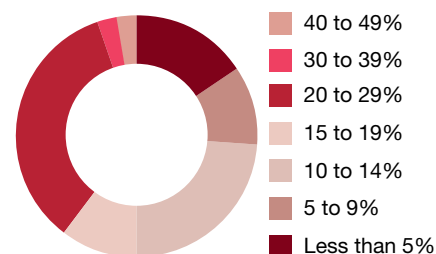
Based on responses from 40 banks in 2009, 2010, 2011 and 2012

Q What was the level of staff turnover in 2011?

In 2011, 13 banks experienced turnover in the 10% to 20% range, while 14 banks recorded between 20% and 40%. This was higher than in 2010 and in 2009 when turnover rates dropped in response to the global financial crisis.

Predictions made in this survey suggest that foreign banks anticipate turnover rates to increase this year. Foreign banks' improved growth aspirations and increased demand for skilled personnel have boosted employees' confidence to switch jobs. Growth in other areas of the financial sector is a further impetus.

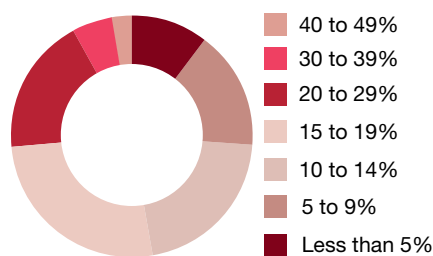
Staff turnover in 2011



15 banks recorded 20% or greater

Based on responses from 38 banks

Anticipated staff turnover in 2012



10 banks recorded 20% or greater

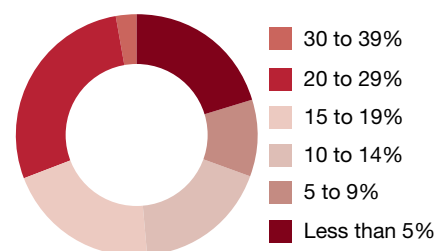
Based on responses from 38 banks

Anticipated turnover in 2012

Approximately half of the respondents anticipate staff turnover in 2012 to be in the 10% to 20% range. Ten banks expect that it will rise above 20%, with one predicting turnover of around 40%. However this is an isolated case and reflects in part the bank's desire to refresh its personnel and their skill sets.

As noted in last year's survey, the larger foreign banks continue to be vulnerable to other foreign banks' recruitment efforts. One of the larger foreign banks noted that they have lost "whole teams" of employees to aggressive poaching efforts by other foreign banks.

Staff turnover in 2010



12 banks recorded 20% or greater

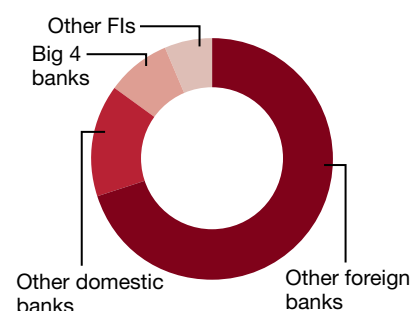
Based on responses from 38 banks

Where did they go?

In this year's survey, participants were asked where their questioned about the destination of departing employees went.

Thirty five banks said they lost employees to other foreign banks; only four had lost employees to the Big Four foreign banks and seven to other domestic banks.

Where did they go?



Based on responses from 38 banks

Q In 2012, will base salaries remain the same, increase or decrease?

Significant salaries increases are expected to continue in 2012. In 2009, 23 foreign banks suggested salary levels would remain unchanged. By 2011, all survey participants anticipated salary increases.

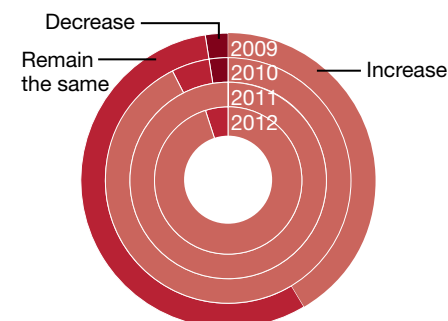
Despite the fragility of the Chinese economy in 2012, only two of the 40 respondents suggested salaries would remain unchanged with the rest saying they would increase.

The two banks that said current salaries would be frozen were both European lenders.

One Asian bank said that potential new employees have asked for salary increases of 20% or more and some have asked for a 50% increase.

Another European bank said that domestic bank employees' salaries were growing at a rate of 14% to 15% per year.

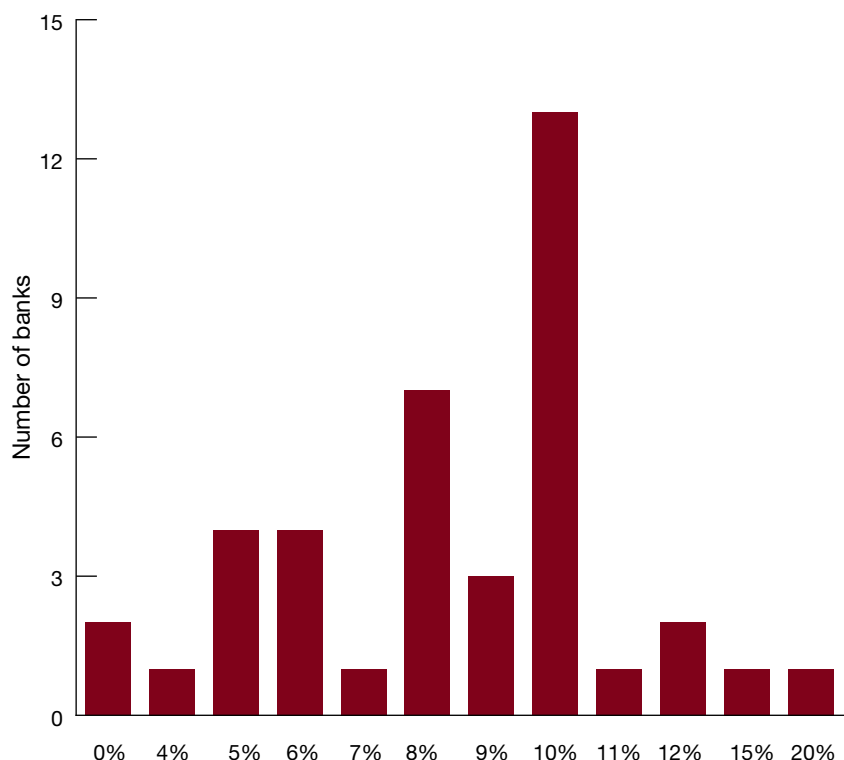
Salaries in 2012



Based on responses from 40 banks in 2012 and 2011, 41 banks each in 2010 and 2009

Q Can you give us an indication of the percentage increase in salaries in 2012?

Percentage increases in salaries in 2012



Based on responses from 40 banks in 2012

Q In 2012, will incentives and bonuses remain the same, increase or decrease?

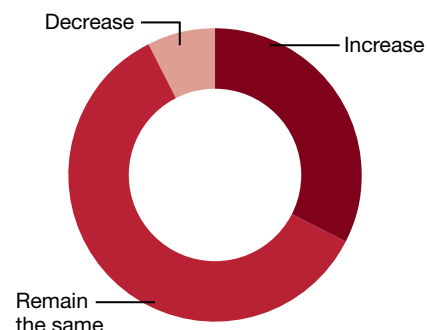
Results from the survey suggest that a more measured approach will be taken with regards to incentives and bonuses in 2012.

Twenty four banks plan to keep bonuses at the same level as last year.

Thirteen banks will increase their bonuses over last year, while three banks will reduce their bonuses. Increases tend to fall in the 5%, 8%, and 10% range.

One North American bank said their bonuses in 2012 would increase by 18%.

Incentives and bonuses in 2012



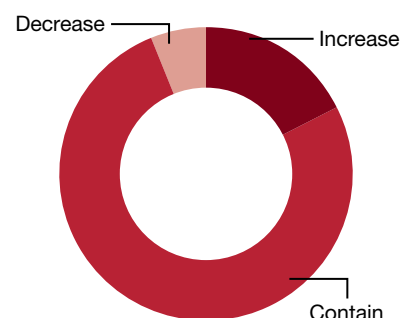
Based on responses from 40 banks in 2012

Q Do you plan to reduce or contain overall human resource costs in 2012?

Given that China remains a growth market, respondents said they are under less pressure to lower human resource costs than those in other markets.

While they are not under pressure to reduce overall costs, these banks said there's a need to seek continuous improvements in productivity. Indeed, only two European banks said they would implement costs cuttings. Several banks said they were expanding, with one saying they were "hiring aggressively".

HR costs in 2012



Based on responses from 34 banks in 2012

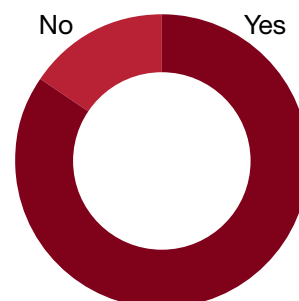
Q Over the next three to five years, will you have the people to deliver your business strategy?

The majority of participants believe that they have the people to deliver their business strategy although many expressed reservations concerning particular needs.

Several, for example, mentioned problems recruiting senior management personnel. A number would like to localise these functions but are unable to find the key people. In particular, there appears to be a shortage of local senior management that are able to “think strategically”.

Front line personnel, especially relationship bankers, was mentioned frequently by participants. Other areas where shortages exist include compliance, risk management, treasury, wealth management, cross border experience, trade finance and financial instruments.

Can you deliver your business strategy?



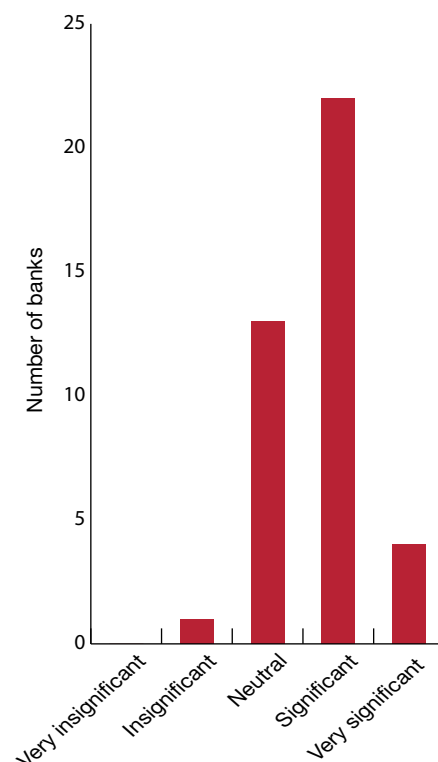
39 banks said they could deliver

Q How significant will the impact of talent shortages be on top line growth over the next three years?

When asked to assess the level of impact personnel shortages might have on foreign banks over the next three to five years, 22 banks said a significant impact and four banks a very significant impact.

Twenty two foreign banks said personnel shortages will have a significant impact on their top line growth over the next three years. Four banks said the impact will be very significant.

Impact of talent shortages on top line growth



Based on responses from 40 banks

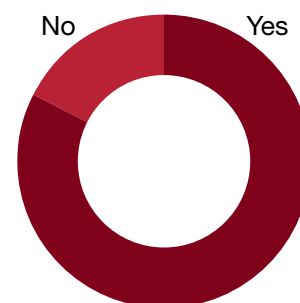
Q Do you feel confident that your current talent management programme will deliver on your succession planning and growth requirements in the future?

In response to whether the current talent management programme can deliver on both the banks' succession planning and future growth requirements, 38 respondents said "yes".

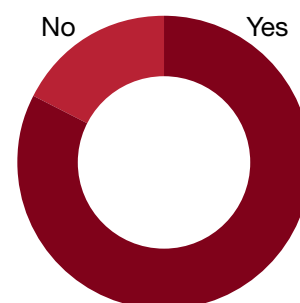
Comments by banks that replied negatively included reference to high turnover and the need to grow more management talent locally. Several banks stressed that they had sophisticated talent management programmes in place. An European bank said it operates a bank academy in Shanghai.

However, it is also clear that banks that said they could deliver on these two fronts were often cautious about the future.

Succession planning



Future growth requirements



Q To what degree have you needed to adapt your home culture and processes to provide the flexibility of doing business in China?

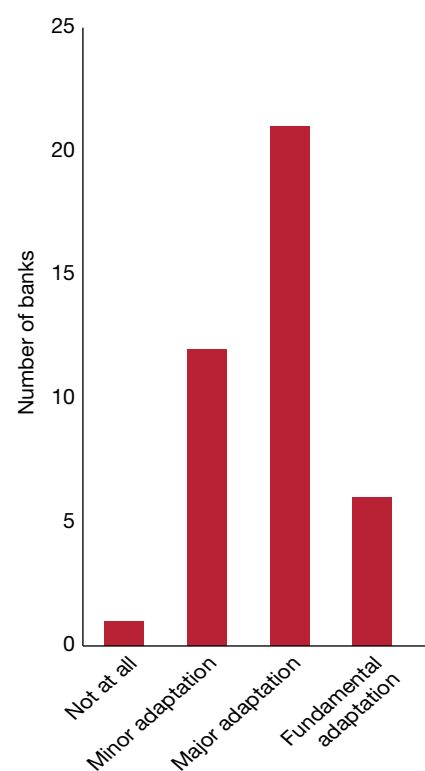
To be successful in China, foreign banks need to make major operational adaptations to how they do business.

Twenty one banks have made major adaptations and six have made fundamental adaptations.

Banks that have a retail presence noted that they have needed to make adjustments to the local market requirements.

Some respondents mentioned the challenges associated with the regulatory environment but others stressed the need to adapt local employment norms and methods when dealing with staff.

Level of cultural adaptation to Chinese market



Based on responses from 40 banks

Q Which staff functions have the highest hiring priority in 2012? Can you rank the top three?

The four most important staff functions in 2012 were identified as :

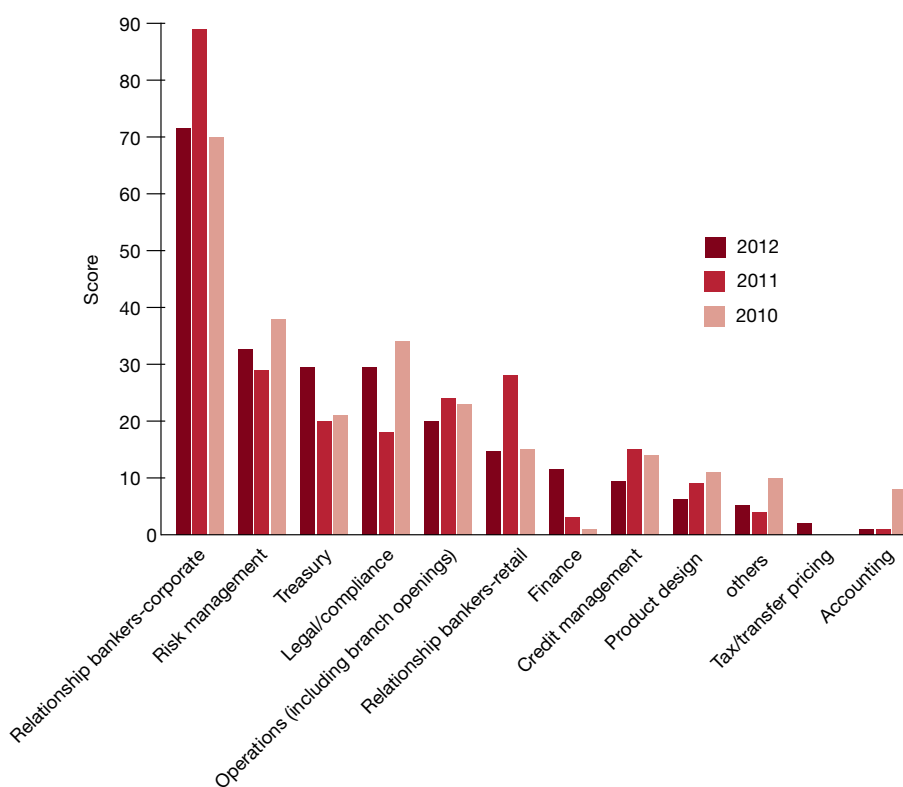
- corporate relationship bankers
- risk management
- treasury, and
- legal/compliance

Corporate relationship bankers continue a three-year trend of being the most critical function and underscores the continued focus on corporate banking growth.

Risk management recorded a similar score in 2011.

Treasury and legal/compliance both gained importance in 2012.

Branch operations staff and retail bankers remain important to the foreign banks that have a growing retail presence.



Based on responses from 38 banks in 2012, 40 banks in 2011 and 41 banks in 2010; not all banks provided three rankings

Risk management and regulation

Q The Chinese version of Basel III will entail a new set of differentiated requirement. Will such a development be positive or negative?

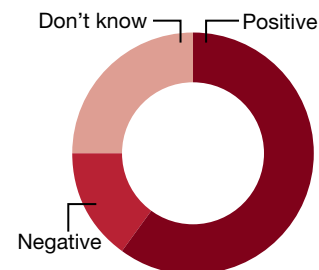
Twenty four of the 40 respondents believe that the move towards a Chinese version of Basel III will be positive.

However this group noted that the details of how China might adopt Basel III remain unclear.

Improved risk management, greater transparency and new capital requirements for domestic banks were all viewed positively. However, there was some apprehension on how these rules might apply to foreign banks in China. For example, one large locally incorporated foreign bank said that the strict loan provisioning rules could penalise foreign banks that already have sound provisions.

In general foreign banks believe that it would help level the playing field and make them more competitive. Twenty five percent however acknowledged that because the details were not yet fully defined, they were unable to predict the outcome.

Chinese banks' adoption of Basel III



Based on responses from 40 banks

Q How would you describe the current environment for corporate credit? Is it improving, stable or deteriorating?

Credit rating agencies are developing in China. The following three agencies are members of Associated Credit Rating Agencies in Asia - ACRAA.

- Dagong Global Credit Rating
- Shanghai Far East Credit Rating, and
- China Chengxin International Credit Rating

Q Can you comment on asset quality in specific sectors that have had the greatest impact on foreign banks?

The participants believe that corporate credit is stable at present. However, 16 banks believed it is deteriorating.

In last year's report, seven banks described it as deteriorating and in 2010 only two banks held this view.

According to a report published in China Daily in May 2012 non performing loans increased to RMB 438 billion (\$69.5 Billion) at the end of the first quarter of 2012. (See following page). This was the third quarter in succession that NPLs had increased.

Several participants agreed that the economy was fragile and softening. In addition they believe that the slowdown in Europe will impact on China.

Participants expect that the handful of foreign banks active in the SME sector will be most exposed to any further deterioration in corporate credit.

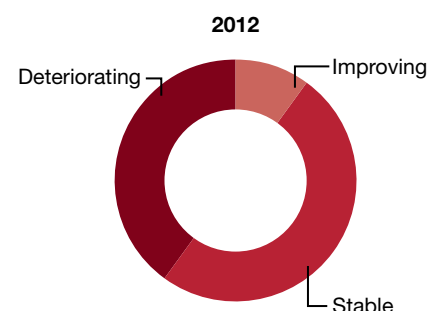
The participants identified sectors of the economy where loan quality might impact on foreign banks.

The sectors mentioned were as follows :

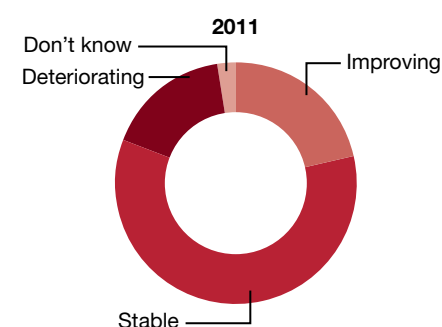
- real estate, including property development and construction companies
- import/export businesses and trading houses
- local government lending
- industries supported by infrastructure development such as cement
- steel production
- commodities related to the domestic economy.

As only a few foreign banks have an active presence in the SME sector, the current economic slowdown will have a limited effect on foreign banks.

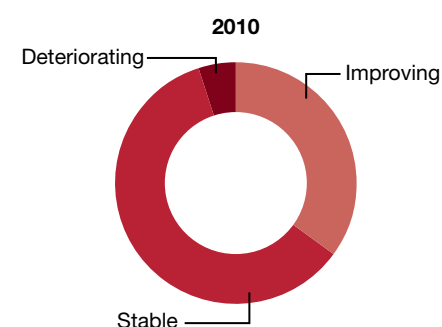
Corporate credit 2012



Corporate credit 2011



Corporate credit 2010



Based on responses from 40 banks in 2012, 42 banks in 2011 and 40 banks in 2010

Corporate debt burden a systemic risk

“Extremely” high corporate debt ratios pose a systemic risk to the world’s second-largest economy, one that will persist as long as bank debt dominates total financing, a senior government adviser said on Thursday.

Li Yang, deputy head of the Chinese Academy of Social Sciences, a government think tank, said China’s total debt to GDP ratio is 168.9 percent, a “healthy” figure considering that the global average is 200 percent, and is 500 percent in some large economies.

“But debt among enterprises amounts to 105.4 percent of GDP, which is the highest compared with other countries such as the United States and Japan.”

Li said the figure far exceeds the generally accepted safety ceiling of 80 percent. “If the economy keeps slowing, the probability of default will increase more rapidly, given that the majority of the debts involve bank loans. “The non-performing loan rise among lenders will threaten the financial system as well as the whole economy,” he said. Bank loans account for 60 to 70 percent of all financing, said Guo Shuqing, China’s top securities regulator. Although the nation’s overall debt ratio is “safe”, it is rising and will continue to rise, given the historical pattern of ratios surging after economic crises, Li said.

Li made the remarks at the 37th annual conference of the International Organization of Securities Commissions in Beijing. He said the most fundamental way to deal with the problem and avoid systemic risks is to speed up the development of the capital market and ensure that companies can raise capital by other means than bank borrowing.

“For instance, the government should allow more companies to list their shares and issue corporate bonds, and it should promote the (use) of derivatives.” Concerns over banks’ asset quality have been deepening since the government reported that China’s economy grew 8.1 percent in the first quarter, the slowest rate in almost three years.

In addition, the growth rate of the government’s total fiscal income, which would back up the financial system, dived to 6.9 percent in April from 18.7 percent in March and an average of 25 percent last year, according to a statement from the Ministry of Finance last Friday. Commercial banks’ outstanding NPLs increased for a second straight quarter for the first time since 2005, the China Banking Regulatory Commission said on Thursday.

Bad loans stood at 438.2 billion yuan (\$69.5 billion) at the end of March, up 10.3 billion yuan from three months earlier. The NPL ratio narrowed to 0.9 percent of total lending, however, from 1 percent in December. NPL risks could be lower than expected this year, said May Yan, director of Barclays Capital Asia Ltd. Banks are at the beginning of a rising non-performing loan cycle.

However, official data show that they have built up strong buffers to absorb increased credit costs, said Hu Bin, a Moody’s vice-president and senior analyst.

China’s non-performing debt and special-mention loans (those that might turn bad) were “vastly understated” and banks’ cushions are “thinning as deposit growth slows and forbearance reduces loan repayments”, Fitch Ratings was quoted by Bloomberg as saying.

Yuan-denominated deposits among the lenders shrank by 465.6 billion yuan in April, while they extended 681.8 billion yuan in new loans in the month, according to the central bank.

Source: China Daily 18 May 2012

Q How would you describe the current environment for consumer credit? Is it improving, stable or deteriorating?

Fifteen of the 20 foreign banks that offered an opinion on consumer credit believe that it is stable. Only five banks said it is deteriorating.

These opinions contrast with previous reports in which respondents signalled that the environment for corporate credit was more positive.

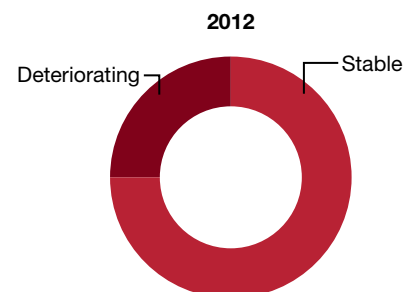
2012 is the first year in which none of the respondents expressed an opinion that consumer credit was improving.

Twenty five percent of respondents in 2012 believe it is deteriorating.

Slowing economic growth in China and uncertainties surrounding the global economy will have an impact on consumer confidence and behaviour in the immediate future. However, rising incomes and higher consumption over the medium and long term will likely boost consumer demand for credit.

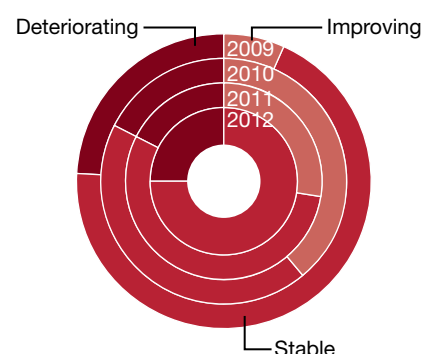
According to McKinsey's "Meet the Chinese Consumer of 2012" released in March 2012, China's transition from investment-led to consumption-driven growth will depend on several factors. They are continuous and rapid urbanisation, government measures to improve social security and spur private consumption, as well as financial sector and industrial reform measures that will increase service sector employment and incomes.

Consumer credit 2012



Based on responses from 20 banks in 2012

Consumer credit 2009 to 2012

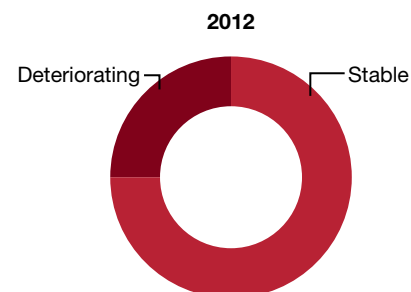


Based on responses from 20 banks in 2012, 29 banks in 2011, 23 banks in 2010 and 29 banks in 2009

Q How would you describe the current position for market risk: Is it improving, stable or deteriorating?

The majority of participants believe that their position for market risk is stable at present. However none of the participants contends that it is improving.

Market risk



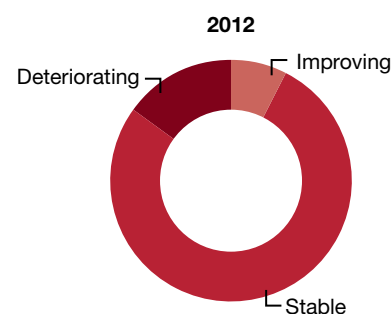
Based on responses from 40 banks in 2012

Q How would you describe the current position for operational risk: Is it improving, stable or deteriorating?

Thirty one banks described their position for operational risk as stable. Three foreign banks (one North American and two European banks) believe it is improving.

Six participants – four European banks and two Asian banks – contend that their position for operational risk is deteriorating.

Operational risk



Based on responses from 40 banks in 2012

Q What are the most difficult regulatory issues that your bank in China has to address at this time?

The most difficult regulation that participants identified was fee-based income. Several respondents said that the CBRC had required them to display publicly their fee schedule. A few added that the CBRC had undertaken inspections relating to their fee structures and practice.

The second regulatory issue that was cited as requiring increasing attention was fund management, followed by QFII and QDII, and bancassurance. Still, several banks said they expect policies on QFII and QDII to be relaxed.

Two participants said regulatory changes should be referred to as “enhanced” instead of “tighter”.

One participant expects tighter regulation on trade finance and private client business. Another said the banking regulator has plans to make pricing more transparent.

Q In which areas do you anticipate tighter regulation on foreign banks?

**Three measures, one guideline stipulates that working capital loans cannot be used for investments in fixed assets, project financing and shareholdings.*

The participants recorded a variety of difficult regulatory issues in this survey. A number of them suggested that in 2011, the key new regulation was “three measures, one guideline”* while in 2012 the CBRC had turned its attention to fee income. Banks have been instructed to return to their clients fees charged on SME loans.

The loan-to-deposit ratio which is set at 75%, and applicable to all banks, is particularly difficult for locally incorporated foreign banks that have limited branch networks.

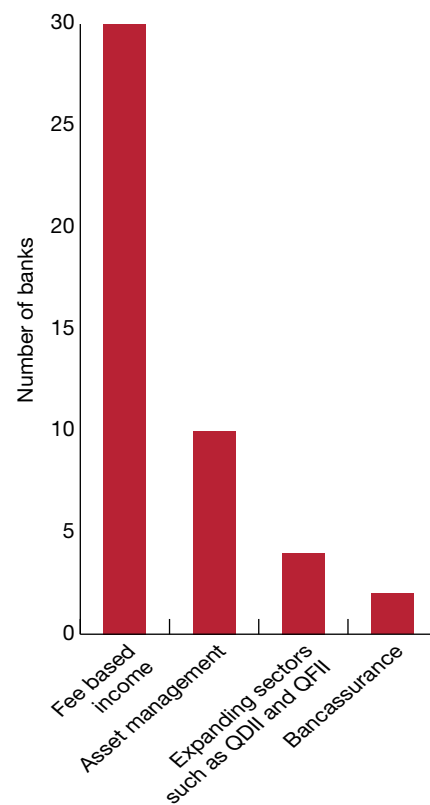
RMB internationalisation and interest rate liberalisation are regulations that the foreign banks are watching closely. They anticipated phased changes which would involve gradual steps towards a more open market.

Other regulations or restrictions that were mentioned include:

- Cross border settlement restrictions
- Branch and sub-branch expansion approvals and the inability to make simultaneous applications
- Restrictions on level of investment in local banks and securities companies
- Chinese Basel III
- Loan loss provisions
- Capital requirements
- Funds distribution license
- Access to the bond market

The increasing reporting requirement demanded by the CBRC was another regulatory issue cited by some banks. One bank said it now files up to 150 reports each month.

Anticipated tightening of regulation



Based on responses from 40 banks in 2012

Q Compared with 12 months ago, do you consider the regulatory environment for your business outside China to be, more supportive, less supportive or stable?

Participants were asked to compare regulatory trends both in and outside China.

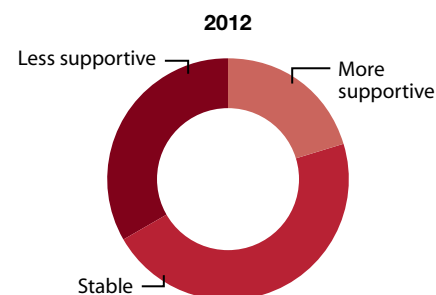
Eight banks said the regulatory environment outside China to be supportive of their business while 13 others said it is less supportive.

Although some other reports have often criticised the CBRC for being heavy handed, these findings suggest that the policies implemented by the banking regulator have been more supportive of banks than those imposed in other jurisdictions.

Six European banks, three North American leaders and two Asian banks said China's banking regulatory environment have been relatively more supportive.

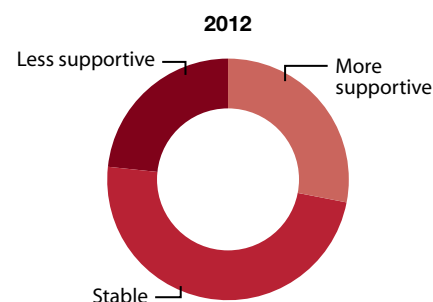
In the CBRC's 2011 Annual Report, Chairman Shang Fulin said, "for those foreign banks operating in China, we provided guidance to help them position better in the local market, and encouraged them to benefit from their expertise in serving the under-banked regions and customers."

Regulatory environment outside China



Based on responses from 39 banks in 2012

Regulatory environment inside China



Based on responses from 39 banks in 2012

Q Please score the importance of these scale of regulatory issues on a 1 to 10. A score of 10 is maximum importance.

The participants were asked to rate the level of importance of nine different regulatory issues on their operations in China. Average scores indicate the importance of each issue. To provide further insight, the scores assigned by individual banks are also shown. This illustrates how some regulations may be more important to some banks because of their strategic direction. For example, the most important regulation within the list – approval for foreign banks to underwrite bonds scored 7.8 out of 10.

However, 25 banks scored it 7 or higher and nine banks assigned the maximum score of 10.

Access to the RMB derivatives market was rated 7 or above by 27 banks.

Capital requirements, CNAPS membership, equal treatment on QDII, branch expansion and access to funding through CFETS (Interbank market) all scored around 6.0, but showed wide variations.

The China Union Pays monopoly only seemed to be an issue for a few banks.

One participant commented that credit cards in China are very unprofitable because of inter bank charges and the inability to charge fees.

To be successful they need economies of scale and require at least 20 million cards.

On capital requirements, participants noted that CBRC requirements can be onerous. However on the other hand if a bank wants to increase its capital it can also be prevented from doing so.

Membership of CNAPS (China National Advanced Payment System) is currently closed to foreign banks wanting to join.

One participant indicated it would re-open in November 2012 while another said it would be mid-2013. Some banks that are not members of the national clearing system are concerned by this delay. The reason given is that CNAPS is being upgraded to CNAPS II. The upgrade will permit the wider use of the Yuan as a cross border trading currency. It will reduce fees and streamline document flow. (See adjacent article)

Score	10	9	8	7	6	5	4	3	2	1	Number	Average
Foreign bank approval to allow bond underwriting	9	3	9	4	2	3		1		1	32	7.8
Access to the RMB derivatives market	7	3	12	5	1	7		1	2		38	7.3
Capital requirements	5	2	7	3	1	7	6	2		1	34	6.4
CNAPS (Advanced payments membership)	3	5	3		1	6	1	4	2	1	26	6
Equal treatment for foreign banks on QDII	2	1	5	4	6	4	1	2	2	1	28	6
Branch expansion (multiple branches and sub branches)	3	2	4	4	2	10	2	2		3	32	5.8
Equal access to the local Fund Agency	1	2	5	4		5	2	2	2	1	24	5.8
Granting permission for local banks to obtain custody licenses to manage insurance funds, private equity etc.	1	1	4	1	3	7		3	3	1	24	5.3
China Union Pays monopoly on clearing and settlement of card transactions			1		1	4		2	3	2	13	3.7

Recent reports on opening up the bond market

Chinese government wants to allow corporate bonds to play a greater role in boosting growth and to divert risk away from the banking system Bloomberg

Corporate bonds and future growth

In June 2012 Bloomberg reported that the Chinese government wants to allow corporate bonds to play a greater role in boosting growth and to divert risk away from the banking system. The CSRC Chairman was quoted saying that the bond market provides only 13% of China's debt, and needs to develop.

CSRC, NDRC (National Development and Reform Commission) and CBRC currently share control of the bond market, but the CSRC website implies that efforts are being made to coordinate bond disclosure, credit rating, investor protection and entry standards.

Bloomberg reported that although foreign banks (through joint venture companies) can trade and underwrite bonds on the CSRC regulated bond market, they are largely prevented from underwriting them on the interbank bond market.

Source: Bloomberg, 11 June 2012

Junk bonds and private companies

In June 2012 the Shanghai Stock Exchange opened its high yield junk bond market. It is estimated that over the next few years that this market could provide \$50 billion capital to private companies

Source: Reuters, 8 June 2012

Q Does the regulatory environment affect the roll-out of certain financial products in China?

The vast majority of participants believe that regulatory controls restrict the introduction of new products.

In providing examples of products that remain tightly regulated most participants cite derivatives.

Some examples of products affected by regulatory constraints

- Derivatives, currency and interest rate swaps
- Wealth management products
- Securitization
- Commodity hedging
- Credit default swaps (not permitted)
- Cross border trade products
- Restricted in ability to provide acquisition finance
- Structured trade products
- Structured deposit products
- QFII
- Distribution of Mutual Funds*

*In the third round of the Strategic Economic Dialogue between the United States and China (2011) it was announced that locally incorporated foreign banks could apply for business licenses to permit them to distribute mutual funds on the same basis as local banks. However, at the time of this survey foreign banks had not been able to commence mutual fund sales.

According to the 2011 CBRC Annual Report at the end of 2011, five locally incorporated foreign banks were authorised to issue RMB financial bonds and 25 foreign bank branches and 25 locally incorporated foreign banks were authorised to engage in derivatives.

Bond Volume Growth

Corporate and government bond volumes grew throughout 2011. Although China has become the largest corporate bond market in Asia, excluding Japan, corporate bonds still account for a relatively small portion of the total sector funding.

At the end of 2011, China's interbank market bonds outstanding totaled approximately RMB 7.8 trillion (US \$1.24 trillion), consisting of

RMB 1.7 trillion (US \$267.7 billion) in government bonds (21.8 percent),

RMB 1.4 trillion (US \$220.5 billion) in central bank bills (17.9 percent),

RMB 2.5 trillion (US \$393.7 billion) in financial institutional bonds (32.1 percent), and

RMB 2.2 trillion (US \$315 billion) in non financial corporate debt financing instruments (28.2 percent).

(Source: American Chamber of Commerce, White Paper, Bond Market Section, 2012)

China Is Easing Yuan-Pay

China is developing a payment system that will make it more efficient for banks to clear yuan funds across its borders, in another move aimed at promoting the global use of the Chinese currency.

The People's Bank of China, the country's central bank, is in the process of upgrading what is known as China's National Advanced Payment System, or Cnaps, to better facilitate cross-border trade denominated in yuan, according to government officials and executives at Chinese banks. The processing of yuan payments isn't at the same level of efficiency as a cross-border payment in other major currencies like U.S. dollars, with a hands-on system that often leads to high transaction costs, some observers said.

China is building out a payment system that will make it more efficient for banks to clear yuan funds across its borders. "The processing cost of yuan payments must come down, so that when corporations do start to put significant yuan volumes through, banks can handle them smoothly and efficiently," said Patrick de Courcy, head of markets in the Asian-Pacific region for Swift, which operates a world-wide financial-messaging network between banks and other financial institutions.

Mr. de Courcy said China's central bank has agreed to use messaging standards adopted by Swift to support electronic payments into its system. A central-bank official confirmed the bank is upgrading the yuan-payment system. The bank declined to comment further.

The move comes as Beijing speeds up its efforts to give the yuan a more prominent role in international trade, even as it is slowing down the appreciation of the currency in the face of weakening exports. The yuan rose 4.6% against the dollar last year and has risen 8.5% since June 2010, when China dropped the yuan's two-year peg to the U.S. dollar and pledged to make the exchange rate more flexible.

Many analysts expect the yuan to rise at a slower rate—by about 3%—this year, as China balances its need to help prop up exports with continued U.S. pressure to let the currency rise to rebalance bilateral trade. At the same time, economic woes in Europe and the U.S. have undermined market confidence in the dollar and euro, giving China an opportunity to accelerate its push for a more global yuan.

"The key story this year is going to be more about internationalization and less about appreciation," said Paul Mackel, head of Asian currency research at HSBC Holdings PLC. Banks, both Chinese and foreign, have started to see increasing demand from their corporate customers for the clearing of yuan-denominated transactions since China started to allow cross-border trade to be invoiced and paid in its currency more than two years ago. Yuan-settled trade now accounts for about 10% of China's total trade, compared with less than 1% in early 2010. Analysts at Deutsche Bank AG predict that yuan-settled trade this year will come to 3.7 trillion yuan (\$588 billion), or 15% of China's total trade.

Much of the yuan trade has been cleared through Bank of China Ltd. in Hong Kong, the only yuan-clearing bank designated by the central bank outside mainland China. Some of the trade has been carried out by commercial banks in China that act as agents for banks overseas.

A typical funds transfer works like this: A Vietnamese importer instructs its bank to pay its Chinese seller in yuan. The importer's bank will then debit its account and send a payment order to the seller's Chinese bank. The payment order is then processed through Cnaps, the yuan-payment system, and the Chinese seller's bank is credited for that amount.

But processing yuan payments into Cnaps is often a labor-intensive process. For instance, that Chinese seller's name in Chinese has to be converted to four-digit codes supported by an international messaging service adopted by Swift and back to Chinese again for processing. The yuan-payment system, once improved, will adopt the Swift standards and help smooth out the process by making it more electronic, according to observers.

"With an upgraded Cnaps, clearing cross-border yuan trades will just be like driving on a highway," said Feng Shenjiang, general manager of the international business department at China Merchants Bank, which saw its yuan-settlement business reach 114 billion yuan last year, quadruple the amount in 2010.

Source: Wall Street Journal, 5 January, 2012

Strengthening supervision on foreign banks' liquidity risks

In 2011, under the backdrop of increased volatility in the international financial market, the CBRC timely adopted targeted measures to strengthen liquidity risk supervision of foreign banks.

1. Reinforcing risk monitoring, assessment and management. Since foreign banks are more closely connected with the international economic and financial environment, and more heavily dependent on the support of their parent companies in respect of liquidity, the CBRC closely kept track of the market development and changes, monitored foreign banks' performance dynamically, evaluated potential regional liquidity risks, and strengthened risk warning on sovereign risks.

Additionally, targeted on-site examinations were performed to assess foreign banks' capabilities in managing local liquidity risks. Banks were also required to rectify identified weaknesses and guard against liquidity risks by holding more assets in local currencies, optimizing stress testing methodologies and etc.

2. Urging foreign banks to match the maturities of assets and liabilities. Through making briefings on the latest economic situation and symposiums on loan-to-deposit ratio as well as individual consultancy, the CBRC asked foreign banks to proactively expand deposit sources, reasonably adjust loan growth rate and establish scientific internal monitoring and assessment mechanisms for loan-to-deposit ratio so as to ensure the ratio to be maintained at a reasonable level in the long term. As of the end of 2011, all the 39 locally incorporated foreign banks were up to the requirements when the grace period of the loan-to-deposit ratio supervision on foreign banks was due.

Source: CBRC Annual Report 2011

Liquidity and funding

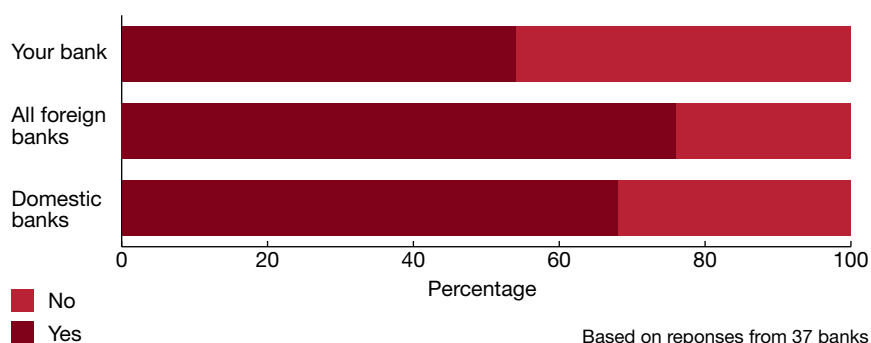
Q Has there been an impact on lending as a result of liquidity issues?

The participants believe that lending has been impacted by liquidity issues. The foreign banks as noted elsewhere are affected by the 75% loan to deposit ratio. Deposits are difficult to generate in the absence of an extensive branch network. One large European bank stressed that most foreign banks were over-capitalised but capital was not taken into consideration of permissible loan volumes.

The foreign banks believe that their domestic counterparts are now under pressure.

The reserve requirement ratio has been relaxed twice in 2012 by the PBOC in an attempt to pre-emptively ease liquidity pressures and inject vitality into the market. The 9.5% drop in May 2012 means that the RRR for large financial institutions was set at 20% and at 16.5% for medium and small-sized financial institutions.

Impact on lending as a result of liquidity

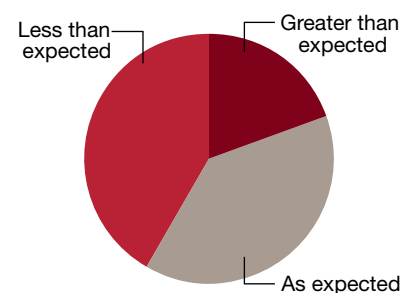


Q Has the growth in locally generated deposits been less than expected/as expected/or greater than expected over the last 12 months?

Seven banks said that locally generated deposits had been greater than expected in 2011. Fourteen banks said they had been as expected but 15 banks admitted that they had been less than expected.

In its Annual Report CBRC announced that at the end of 2011, all 39 locally incorporated foreign banks satisfied the requirements of the loan-to-deposit ratio.

Growth in locally generated deposits



Based on responses from 36 banks in 2012

Q Can you describe your funding sources in 2012 and in 2015 in very approximate percentages?

Thirty five banks provided details on their sources of funding. Seven banks said that 80% or more of their current funding came from their parent.

This number included three banks which indicated that their parent had provided 100% of funding needs.

In total, 30 out of the 35 banks that provided details acknowledged parents as a source. The five banks that did not have parent founding relied heavily on corporate deposits.

Fourteen banks received 50% or more funding from corporate deposits. Ten banks claimed to receive retail deposits.

Two banks indicated around 26% of total funding and two banks around 15% from retail deposits.

Funding sources in 2012

	Parent	Corporate deposits	Domestic banks	Foreign banks	Retail deposits – HNWI/Premier clients>RMB 250K	Retail deposits – Others<RMB 250K	Others
Bank 1		100%					100%
Bank 2		90%			10%		100%
Bank 3	90%	10%					100%
Bank 4	40%	50%	10%				100%
Bank 5	20%	60%			10%	10%	100%
Bank 6	40%	60%					100%
Bank 7	100%						100%
Bank 8	100%						100%
Bank 9		85%			15%		100%
Bank 10	50%	20%	20%	10%			100%
Bank 11	20%	60%	10%		10%		100%
Bank 12	8%	70%	2%		10%	10%	100%
Bank 13		75%			13%	13%	100%
Bank 14	30%	40%	5%		13%	13%	100%
Bank 15		70%	15%	15%			100%
Bank 16	8%	7%	80%	5%			100%
Bank 17	20%	50%	20%	10%			100%
Bank 18	70%	10%	20%				100%
Bank 19	90%		10%				100%
Bank 20	15%	30%	50%	5%			100%
Bank 21	10%	10%		80%			100%
Bank 22	80%		20%				100%
Bank 23	30%	60%	4%	6%			100%
Bank 24	30%	20%	10%	40%			100%
Bank 25	100%						100%
Bank 26	30%	40%	30%				100%
Bank 27	30%	10%	60%				100%
Bank 28	40%	40%	8%	8%	3%	3%	100%
Bank 29	25%	60%			15%		100%
Bank 30	70%	3%	12%	15%			100%
Bank 31	60%	10%	30%				100%
Bank 32	90%		10%				100%
Bank 33	45%	15%	20%	20%			100%
Bank 34	20%	25%	40%	10%	5%		100%
Bank 35	10%	50%	10%	10%			20% 100%
Number of banks	30	29	23	13	10	5	1

Q Can you describe your funding sources in 2012 and in 2015 in very approximate percentages?

By 2015, none of the participants anticipate receiving 100% parental funding. However, six banks will still receive 50% or higher from their parent.

Only one bank did not plan to have corporate deposits by 2015. At that time, 25 banks will meet at least 30% of funding needs through corporate deposits.

By 2015, several participants planned to generate around 30% of funding from retail banking sources.

Funding sources in 2015

	Parent	Corporate deposits	Domestic banks	Foreign banks	Retail deposits – HNWI/Premier clients>RMB 250K	Retail deposits – Others<RMB 250K	Others
Bank 1		100%					100%
Bank 2		70%			30%		100%
Bank 3	n/a	n/a	n/a	n/a	n/a	n/a	100%
Bank 4	30%	60%	10%				100%
Bank 5	10%	65%			13%	13%	100%
Bank 6	40%	60%					100%
Bank 7	70%	15%	15%				100%
Bank 8	50%	20%	30%				100%
Bank 9		65%			35%		100%
Bank 10	40%	30%	20%	10%			100%
Bank 11	20%	30%	20%		30%		100%
Bank 12	5%	55%	5%		18%	18%	100%
Bank 13		65%	5%		15%	15%	100%
Bank 14	30%	40%	5%		13%	13%	100%
Bank 15		70%	15%	15%			100%
Bank 16	12%	10%	68%	10%			100%
Bank 17	15%	55%	20%	10%			100%
Bank 18	70%	10%	20%				100%
Bank 19	90%		10%				100%
Bank 20	15%	30%	50%	5%			100%
Bank 21	20%	40%		40%			100%
Bank 22	70%	10%	20%				100%
Bank 23	20%	65%	5%	10%			100%
Bank 24	30%	20%	25%	25%			100%
Bank 25	50%	50%					100%
Bank 26	30%	40%	30%				100%
Bank 27	30%	20%	50%				100%
Bank 28	20%	50%	10%	10%	5%	5%	100%
Bank 29	20%	60%			20%		100%
Bank 30	42%	11%	31%	16%			100%
Bank 31	33%	33%	22%	11%			100%
Bank 32	40%	40%	20%				100%
Bank 33	35%	25%	20%	20%			100%
Bank 34	10%	40%	20%	10%	20%		100%
Bank 35	10%	50%	10%	10%			20% 100%
Number of banks	29	33	26	14	10	5	1

Q Can you provide details on your loan portfolio?

The loan portfolio displays wide variances across the 31 foreign banks that provided a breakdown. All the participants had exposure to either home country corporates or global corporates. Twenty banks had exposure to global corporates which ranged from 10% to 100%.

In the case of home country corporates, 22 banks had relationships which ranged from 5% to 80%. Indeed five

banks had 50% or more of their loan portfolio allocated to home country corporates.

Twenty two banks had commitments to large listed Chinese companies ranging from 5% to 80% while 17 banks had relationships with Chinese based private corporates.

Only six participants recorded involvement in the SME sector.

Loan portfolio structure

	To Chinese based large listed corporates	To Chinese based private corporates	To Chinese based SME corporates	To global corporates	To home country corporates	To Chinese banks	To foreign banks	Others	Total
Bank 1		20%		80%					100%
Bank 2	20%	20%		25%	25%			10%	100%
Bank 3	30%	30%	10%	10%	20%				100%
Bank 4	50%			50%					100%
Bank 5	30%	30%		40%					100%
Bank 6	30%			30%		40%			100%
Bank 7	30%	20%		50%					100%
Bank 8	20%				50%	30%			100%
Bank 9	80%	10%			10%				100%
Bank 10	40%	20%	20%		10%	5%		5%	100%
Bank 11			30%		70%				100%
Bank 12	10%			70%	20%				100%
Bank 13	5%	5%			80%	10%			100%
Bank 14	50%			25%		20%	5%		100%
Bank 15				100%					100%
Bank 16	40%	10%		20%		30%			100%
Bank 17	15%				80%	5%			100%
Bank 18					20%	80%			100%
Bank 19	40%	5%		10%	30%	15%			100%
Bank 20	30%	20%		30%	20%				100%
Bank 21		70%	25%		5%				100%
Bank 22	10%			35%	10%	40%	5%		100%
Bank 23	60%	15%		20%	5%				100%
Bank 24	20%	25%	10%	15%	15%	8%	8%		100%
Bank 25		5%			5%	90%			100%
Bank 26				10%	40%	25%	25%		100%
Bank 27					50%	20%	30%		100%
Bank 28	60%	20%		10%	10%				100%
Bank 29	20%			25%	25%	20%	10%		100%
Bank 30	20%	20%	20%	20%	20%				100%
Bank 31	20%	20%	20%	20%	20%				100%
Number of banks	22	17	6	20	22	15	6	2	

Q What impact, if any, have the following small loan companies or the shadow banking sector had on your business?

Only three Asian banks indicated that the growing presence of small loan companies and the shadow banking sector had impacted on their business. One suggested that trust companies were entering the lending business. Another said they were aggressive competitors and were often more flexible in their arrangements.

A larger foreign bank noted that these players operated outside the regulatory framework and that the government needed to take action.

Small loan companies

People's Bank of China announced that as of the end of March 2012, there were 4787 small-loan companies in the country with the loan balance of RMB444.7 billion. New loan in the first quarter of 2012 amounted to RMB53.1 billion.

Source: PBOC website

Shadow banking

In 2011, the FSB defined the concept of “shadow banking” from two perspectives.

In a broad sense, shadow banking includes all activities and institutions involved in credit intermediary services, while falling out of the scope of traditional banking system. In a narrow sense, it refers to those non-bank credit intermediary agencies that may lead to systemic risks or regulatory arbitrage. Factors that may cause systemic risks include maturity transformation, liquidity transformation, incomplete credit risk transfer and high leverage ratio. Regulatory arbitrage refers to the rapid rise of “shadow banking” businesses and risk accumulation triggered by the differences in regulation between banks and shadow banking system.

The CBRC has established a fairly comprehensive regulatory system for six types of non-bank financial institutions, including trust companies, finance companies, auto financing companies, financial leasing companies, money brokerage companies and consumer finance companies. According to the definition by FSB, the supervision by the CBRC over non-bank financial institutions does not fall into the scope of shadow banking.

Source: CBRC Annual Report 2011

Q Are there pressures from your head office to reduce the cost of operations in China?

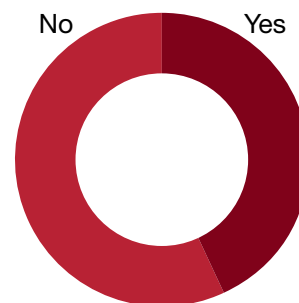
A majority of respondents reported that although they had to manage costs prudently, they were not being pressed to reduce overall costs.

Within the group of 16 banks that said there were pressures, 11 were European banks. Many banks stressed that they continually strived to increase productivity.

Banks that targeted cost reductions mentioned the following areas of attention - personnel costs, travel expenses, office accommodation and general expenses.

Two banks mentioned they were seeking a 10% reduction in overall costs and one bank a 13% reduction.

Head office pressure to reduce cost



Based on responses from 37 banks

Shanghai as an International Financial Centre

Q Has Shanghai's ambition of becoming an IFC affected your business strategy in China?

Brookings has argued that to keep Shanghai moving forward towards becoming an IFC, the authorities need to “foster an environment of innovation, competition and market vibrancy”.*

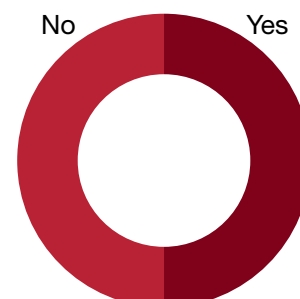
The participants were split 50:50 on whether the ambition to create an IFC in Shanghai influenced their business strategy.

Firstly those that responded negatively questioned whether Shanghai could become a comprehensive IFC by 2020. One Asian bank said it lacked transparency and was weak on compliance. Another Asian bank said the focus should be on customers' needs and not IFC status. A variety of participants cited the attractions of Hong Kong relative to Shanghai and believed that Hong Kong limited Shanghai's potential.

On the positive side, one participant said it would encourage a closer alignment between foreign and domestic banks. An European bank said its Central Treasury had moved to Shanghai and because many SOEs were now listed in Shanghai, Beijing had become less important.

It was widely acknowledged that the pace of RMB internationalisation would influence the scope and status of Shanghai as an IFC.

IFC affected foreign bank strategy



Based on responses from 40 banks

*Source: Achieving 2020 page 8
Brookings Institution 2012

Background on what constitutes an IFC

The following description of the criteria associated with a Global Financial Centre has been extracted from a paper prepared by the Brookings Institution in 2011.

Some of the criteria such as the availability of talent, the legal infrastructure and open financial environment are mentioned on the following page in the context of challenges faced by Shanghai.

As shown below the Brookings paper highlighted the advantages and disadvantages of Shanghai.

Factors associated with an IFC

- Availability of high quality finance professionals
- Quality of life
- English speaking staff
- Rule of law
- Appropriate regulation (financial stability, toughness, predictability, speed)
- Avoidance of excessive taxation
- Proximity to customers
- Core infrastructure
- High quality support services
- Reasonable operational costs
- Openness to foreign entry
- Favorable time zone

How does Shanghai meet these criteria?

Advantages of Shanghai

- Access to a huge and growing Chinese financial market
- The clear backing of the national and municipal governments
- Existence of futures and options markets
- A vibrant city
- Great progress with “hard” infrastructure

Source: Building a Global Financial Center in Shanghai: Observations from Other Centers, John L. Thornton China Center at BROOKINGS, June 2011

Disadvantages of Shanghai

- Limited ability to use sophisticated financial products
- Limited global use of the renminbi
- Opaque political decision processes
- Concern with political favoritism
- Distance from Beijing’s financial institutions
- Hesitation about use of Chinese law for global transactions
- Still modest presence of related services
- Further need to develop “soft” infrastructure

Q In what ways can your bank contribute to the achievement of the IFC ambition in the next 3 years?

The foreign banks are obviously enthusiastic about the liberalisation and reform of financial services. They have already contributed in a variety of ways towards increased internationalisation.

Some of the contributions they have made include:

- bringing commercial banking knowledge to the market
- relocating treasury operations to Shanghai
- injecting equity
- expanding branch and sub-branch networks
- risk management
- environmental protection
- corporate governance
- CSR responsibility
- Ecuador principles
- participants in the mayor's advisory board
- market maker for home country current e.g. Rouble
- capital market development
- training and professional development

Q To achieve IFC status, how critical are RMB internationalisation and interest rate liberalisation?

The participants expressed just how important both the internationalisation of the RMB and liberalisation of interest rates were in the path toward Shanghai 2020.

Forty banks responded to both questions.

RMB Internationalisation

For Internationalisation of the RMB the average score was 9.3 out of 10.

Twenty seven banks allocated the maximum score.

One European bank commented that if the RMB was fully internationalised, then Shanghai might be eclipsed by Hong Kong. They argued that the domestic banks did not want RMB internationalisation until interest rates would have been deregulated. Another bank argued that SAFE (State Administration of Foreign Exchange) would try to accomplish the benefits of internationalisation but at the same time keep control.

Interest rate liberalisation

Liberalisation of interest rates was assigned a marginally lower score of 8.8 out of 10.

Nineteen banks assigned the maximum value.

A hypothetical model for Shanghai

The IMF/World Bank Financial System Stability Assessment Report in 2011 provided a hypothetical roadmap detailing the various components of financial reform. (See below).

The schematic did not include any timelines but it did provide a sense of the steps that would need to be undertaken. It divided the process into three stages.

Stage I

In Stage 1 reform centres on absorbing liquidity; and other processes including strengthening supervision and regulation and increased exchange rate flexibility.

It also envisages the beginning of a more commercial orientation for financial institutions.

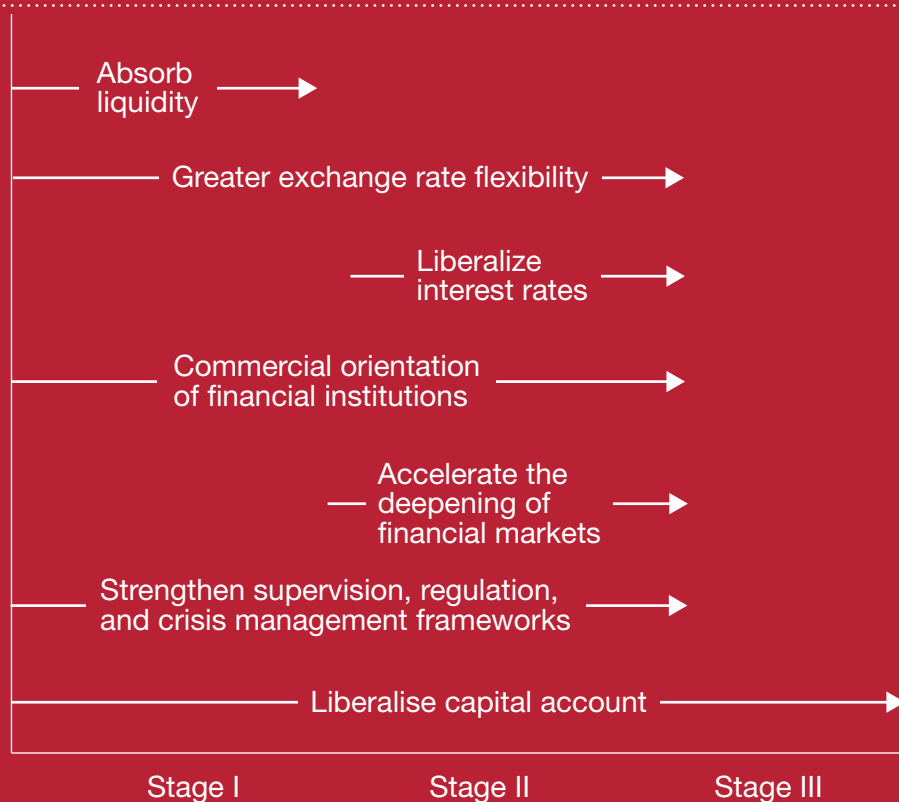
Stage II

By Stage II liberalisation of interest rates takes place and there is an acceleration and deepening of the financial markets.

Stage III

Stage III sees the continued liberalisation of the capital account.

China: Sequencing Financial Reforms (Hypothetical model, IMF/World Bank)



Source: IMF/World Bank Financial System Stability Assessment
June 2011

Q What are the challenges facing Shanghai's progression to an IFC?

The task to establish an IFC by 2020 will require the authorities to overcome a series of key challenges.

One of the most widely cited challenges related to the legal infrastructure. One large North American bank said that it lacked confidence in the litigation and arbitration process. It believed legal reforms could take ten years.

Another common challenge was the role of Hong Kong. The success, breadth and scope of Hong Kong will slow Shanghai's transition. A North American bank argued that Shanghai would face the same challenges as Tokyo. Tokyo serves Japan and not the global market. They contended Shanghai would serve China but not Asia.

Hong Kong will be difficult to displace because of its pool of talent and attractive tax environment.

Regulation will remain a key challenge.

A North American bank said that in Hong Kong a foreign bank was required to file 50 returns annually versus Shanghai with 1,000 returns.

Other participants explained that Shanghai's ambition to become an IFC was "not a destination but a journey" and that there would be no "Big Bang".

Performance

Q What is your business' estimated annual revenue growth in 2012 and over the next three years?

Forty banks provided information on their projected revenue growth in both 2012 and 2015.

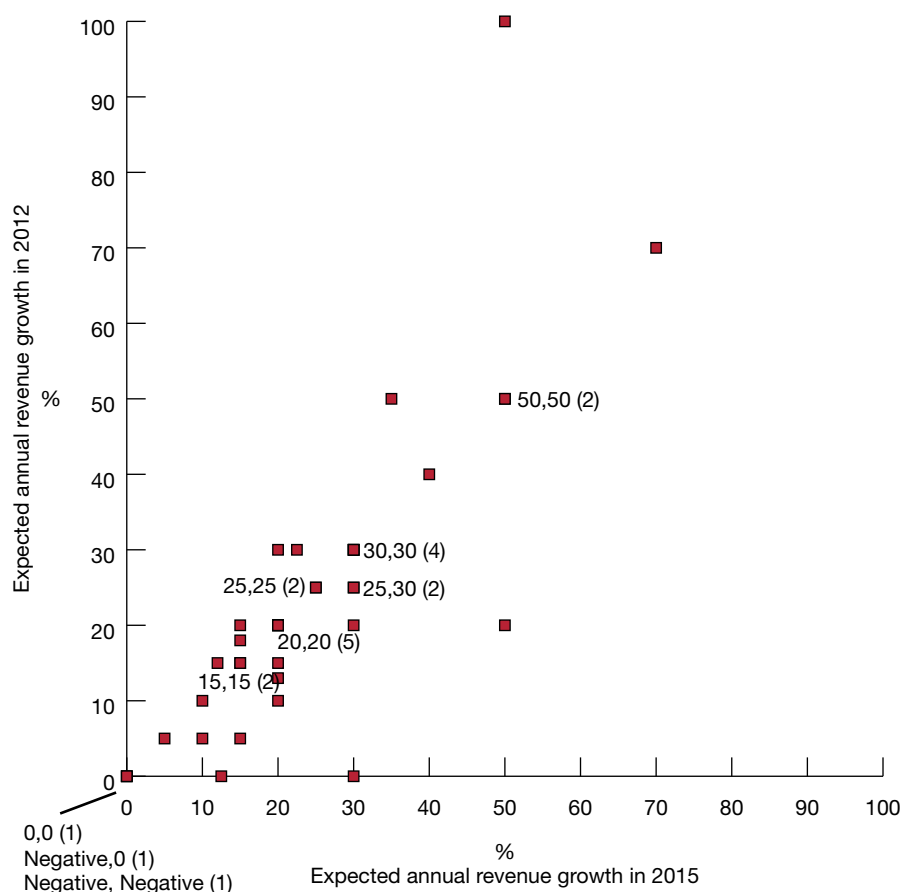
One bank said it was unsure of revenue growth in 2012 and two European banks predicted negative growth.

On a more positive note, 24 banks envisaged growth of 20% or higher in 2012. Eight banks predicted between 10% and 20%.

By 2015, 29 of the 40 respondents expect revenue growth above 20%. Seventeen banks expect growth to be above 30%.

At the lower end of the scale, nine banks expect 10% to 20% growth. Two banks are unsure whether their parent will permit them to grow in 2015 and may therefore remain static.

Projected annual revenue growth for 2012 and 2015



Based on responses from 40 banks

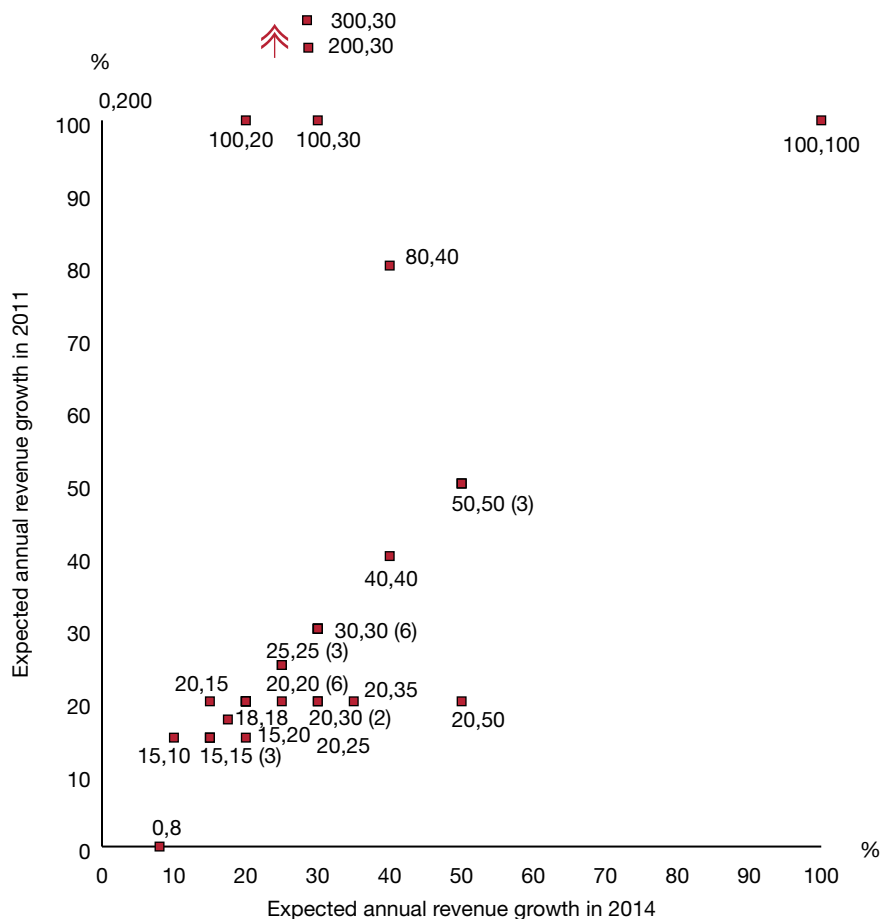
Annual revenue growth projections made in 2011 for 2011 and 2014

Last year's projections

Two banks also indicated they expected zero growth. Twenty two banks anticipated growth between 20% and 50% which was very similar to this year.

However in 2011, six banks expected growth above 50% with several expecting to double or triple in size. These dramatic increases are no longer present this year.

A comparison: Projected annual revenue growth for 2011 and 2014 from last year's survey



Based on responses from 39 banks

Annual revenue growth projections made in 2012 for 2012 and 2015 for locally incorporated foreign banks

Locally incorporated banks

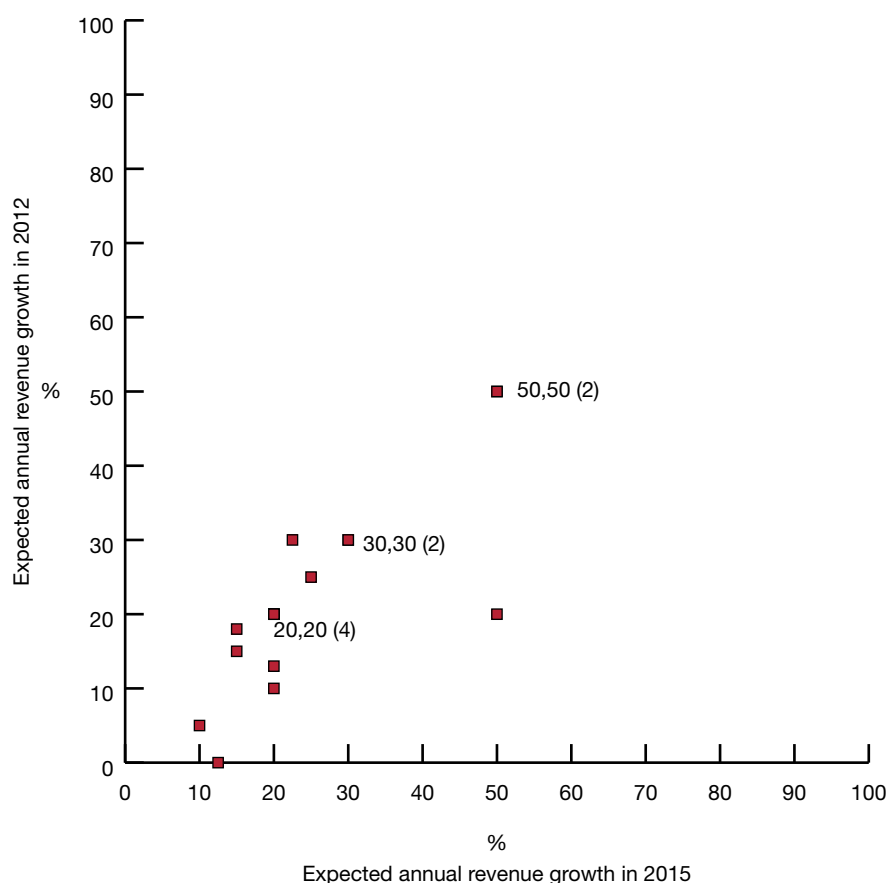
The expected growth in 2012 as estimated by the 17 locally incorporated banks interviewed ranged from 20% to 25%. Five banks anticipated growth of 30% or higher and one bank expected zero growth in 2012.

Going forward, the five banks with an estimated growth of 30% or above expected this level of growth to continue in 2015.

By 2015 all the locally incorporated banks expect growth to be above 10% growing above 20%.

Three banks expect to be expanding by 50% annually in 2015.

Projected annual revenue growth for 2012 and 2015 for locally incorporated foreign banks



Based on responses from 17 locally incorporated banks

Q What were your major revenue growth areas in the past 12 months?

Some of the widely recorded revenue growth areas in the past 12 months were corporate banking, trade finance and treasury and financial institutions related business.

Other areas of revenue growth mentioned were

- private banking
- cash management
- fixed income
- advising Chinese companies expanding abroad
- bonds
- foreign exchange
- commodity financing and
- deposits and investment products.

Q Can you outline the key opportunities for growth for foreign banks in China over the next three years?

Many of the product areas that have delivered growth in the last year are expected to continue into 2015. Debt capital markets, treasury, trade finance and investment products were widely recognised as opportunities for growth.

Other areas mentioned included;

- cash management
- solution based investments – both corporate and retail
- commercial banking but not commercial lending
- structured products
- capitalised-FX
- private equity
- securitisation
- bond market via Hong Kong
- trade services
- private banking
- cross border M & A
- consumer banking as domestic consumption picks up, including personal loans and mortgages
- consumer finance and credit cards
- retail bancassurance
- wealth management
- agricultural and resource sectors
- investment products.

Q What wholesale products do you see becoming increasingly important in the Chinese banking industry in the next three years?

The foreign banks ranked wholesale products that they believe will increase in importance by 2015.

As in previous years the most important product area was debt capital markets.

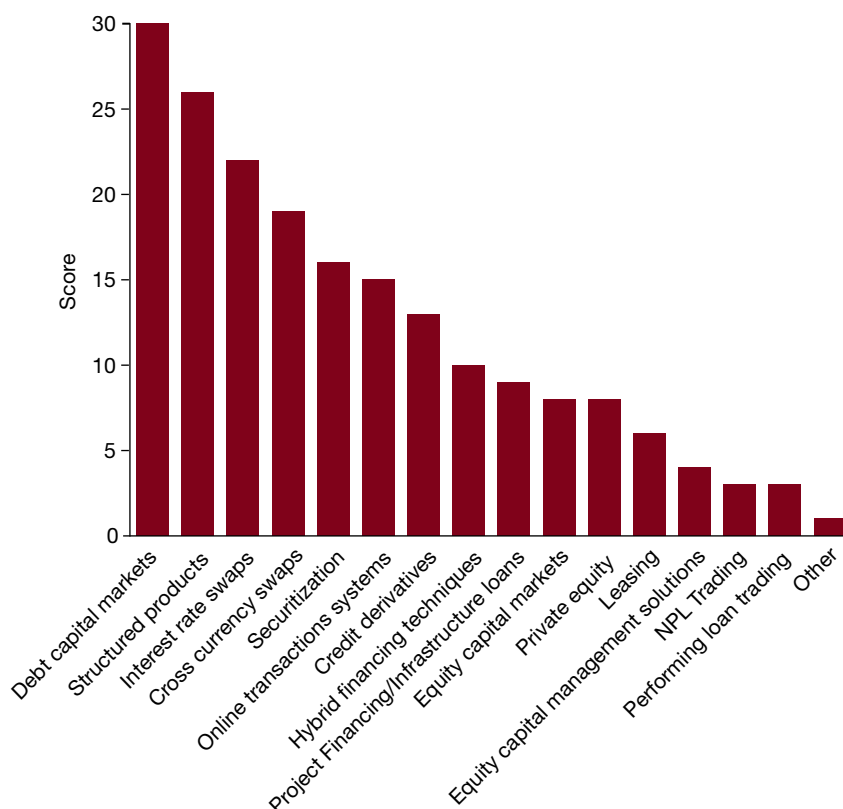
In second place is structured products followed by interest rate swaps and cross currency swaps.

Securitisation which in previous surveys had been placed in 10th position was elevated in 2012 to fifth position.

Hybrid financing techniques moved up by three places in 2012 to eighth position.

	2012 Rank	2011 Rank	2010 Rank	2009 Rank
Debt capital markets	1	1	1	1
Structured products	2	4	2	5
Interest rate swaps	3	3	4	3
Cross currency swaps	4	2	5	5
Securitization	5	10	10	14
Online transactions systems	6	6	11	10
Credit derivatives	7	9	12	12
Hybrid financing techniques	8			
Project Financing/Infrastructure loans	9	5	9	2
Equity capital markets	10			

Important wholesale products over the next three years



Based on responses from 40 banks in 2012

Q Which product areas do you see becoming increasingly important in the Chinese retail banking industry in the next three years?

The top three products on the retail side are the same as last year but the rank order has changed.

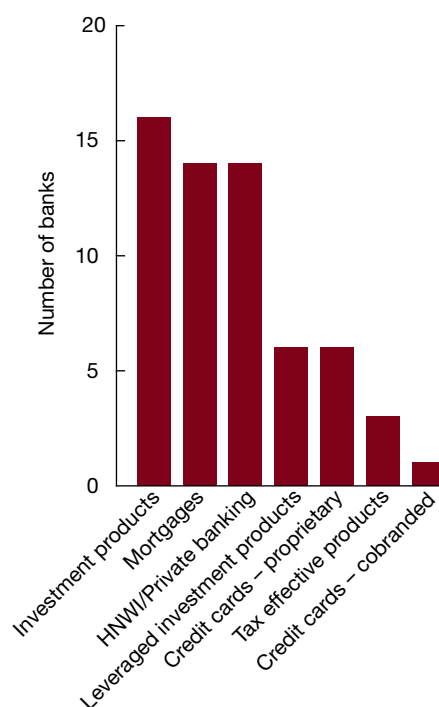
Perhaps anticipating the deregulation of interest rates, investment products are ranked in first place. Mortgages and HNW/Private banking share second position.

Fitch Affirms China's 5 State-Owned Commercial Banks

One key risk over the short-term is Chinese banks' rapidly growing wealth management offerings, of which state banks are the leading issuers. At end-Q112, Fitch estimates that the amount of outstanding wealth management products in the banking system reached CNY10.4trn. While this represents a relatively low 12% of total deposits, an estimated half of all new deposits are raised through these products. Poor matching of the maturities of the liabilities with the assets underlying the products means banks often do not have money coming in on the products to repay investors upon maturity. Instead, banks often rely on new issuance or product rollovers to repay investors. Given how important this activity is to deposit growth, any disruption could further weaken state banks' funding and liquidity.

Source: Fitch Ratings Press Release 21 May 2012

Important retail products over the next three years



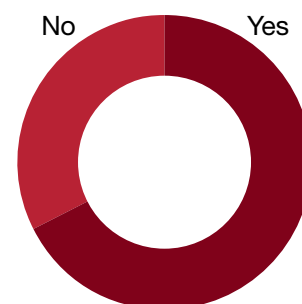
Based on responses from 21 banks in 2012

Q Does your bank have a derivatives license?

Twenty eight of 41 respondents said that they possessed a derivatives license. Eight of the 13 banks that do not have a license said they had applied for one. One bank hoped it would be granted by 2014.

Another bank said that because they could only be issued one license at a time, they were now in a 12-month observation period. Banks are required to obtain an RMB license first.

Derivatives license



Based on responses from 40 banks

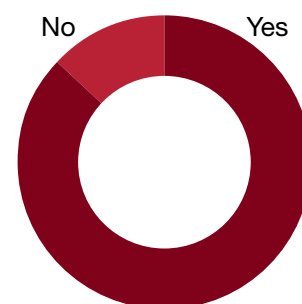
Q Do you see derivative/structured products as major growth areas for foreign banks?

Thirty three of 39 participants believed derivative/structured products to be a major growth area for foreign banks.

Those who said no cited heavy regulation, unwillingness of customers to pay for derivatives and a reticence of some Chinese corporates to use derivatives because of past losses.

Two of the largest foreign banks believed that there was currently negative sentiment towards structured products.

Derivatives and structured products will be a major growth area



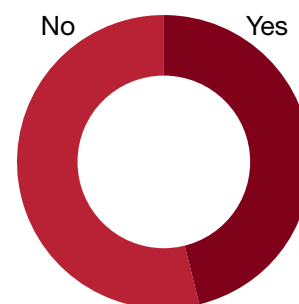
Based on responses from 39 banks

Q Do you undertake proprietary trading?

Although there are different definitions of proprietary trading, 18 of the 40 participants said they were involved in proprietary trading.

Several of those that responded affirmatively acknowledged that it was only on a very small scale and several mentioned that their interpretation did not match the Volcker definition. For example, if they trade foreign exchange, is that proprietary trading or simply liquidity management?

Proprietary trading



Based on responses from 39 banks

Q In your pursuit of growth which customer segments will you expand over the next 3 years? Can you score each on a scale 1 to 10? Where 10 is maximum interest.

The table below sets out the banks' targets in their pursuit of growth over the next three years.

Because of the varied target markets and niches of the foreign bank community, averages do not tell the full story.

Four types of targets, financial institutions, global corporations, state owned enterprise (SOEs) and privately owned enterprises (POEs) scored

respective averages of 7.5, 7.4, 7.3 and 7.2. However, 15 banks scored 10 out of 10 for SOEs and 13 for global corporations. Twenty three banks scored financial institutions at 8 or higher.

High networth individuals were scored at the maximum level by eight foreign banks. Small and medium enterprises (SMEs) produced the lowest average - 4.2 although three banks assigned the maximum value.

Level of interest in various market segments over the next three years

	Average	10	9	8	7	6	5	4	3	2	1
SOE (39)	7.3	15	3	3	4	3	5	1	1	1	3
POE (33)	7.2	7	2	10	6	3	3	1	1	2	1
Local SME (31)	4.2	3	2	3	1	2	3		2	2	13
Financial Institution (37)	7.5	9	5	9	3	2	6		2		1
Global Corps. (38)	7.4	13	2	9	2	3	3	2		1	3
High Net Worth Individuals (25)	6.2	8	3	3	1		1		1		8

Based on responses from 39 banks

Figures in parentheses are number of respondents

Q What is the possibility that the following changes in monetary policy will be used to ease funding restrictions over the next year? (Scale 1 to 5 from 1 highly unlikely to 5 highly likely)

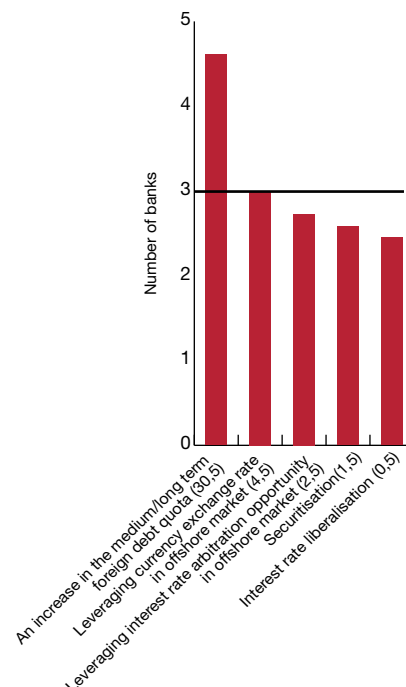
Previous questions explored the foreign bankers' assessment of a number of regulatory changes occurring in the next year. Five different regulatory scenarios were suggested. However only one appears likely in 2012. Indeed many participants suggested this had already occurred. Many foreign banks have received increases in their medium and long term debt quotas at the time of this research.

The next most likely form of change is the ability to leverage currency exchange rates in the offshore market. However, the remaining changes in monetary policy, such as leveraging interest rate arbitration in offshore markets, securitisation and interest rate liberalisation are all unlikely to occur in the next year.

One North American bank said that leveraging interest rate arbitration in offshore markets was actively discouraged by the Regulator.

A large European bank predicted that securitisation was five years away. The interest rate liberalisation will take time but will happen in incremental steps.

Policy changes



Based on responses from 38 banks
Figures in parenthesis show number of banks that scored the maximum 5 out of 5

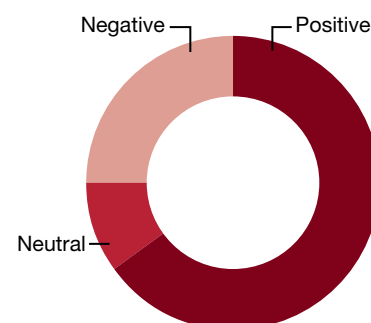
Based on responses from 38 banks

Q Will the impact of interest rate liberalisation have a positive/neutral/negative impact for your bank?

The foreign banks believe that interest rate liberalisation will be a positive development in China and product view opportunities for them.

The minority of participants that took a negative position cited the attractive fixed margins that existed in the current regulated environment.

Interest rate liberalisation



Based on responses from 40 banks

Q Will the aggregate market share of the foreign banks in China (vs local banks) continue to increase, stay the same or decrease?

Twenty six banks believe that the status quo will continue in 2012 and foreign bank market share will remain the same. At the end of 2011 market share was 1.93%.

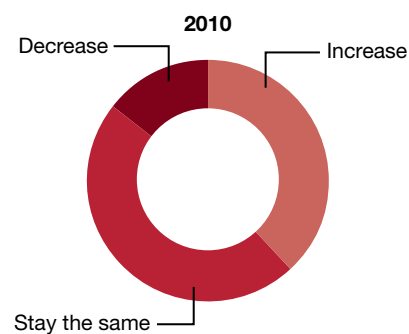
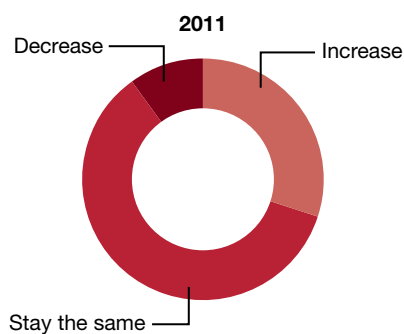
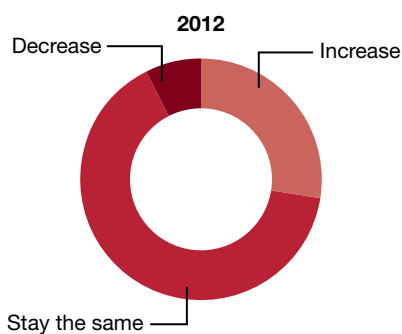
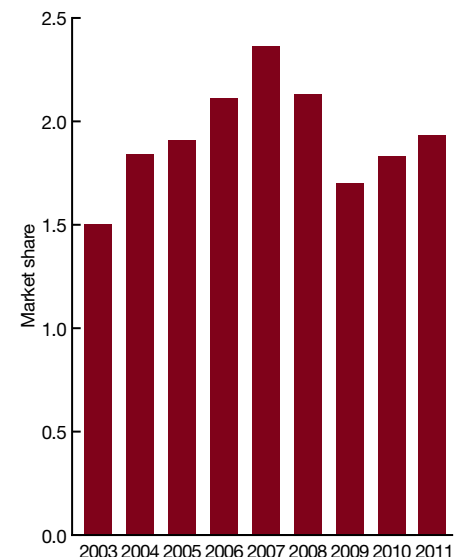
Eleven banks optimistically believe it will increase and three banks think it will decline.

Those who think a marginal increase in market share might be possible, based on a slower rate of growth for the domestic banks.

One European bank believed that over 10 years it might expand to 5% from its current level of below 2%. A North American bank said that last year the foreign banks had achieved greater profitability and they believed this performance could continue if the foreign banks stayed in their narrow market niches.

Another foreign bank suggested that market shares were misleading and that in Shanghai, the foreign banks had 10% market share versus less than 2% nationally.

Market share for all foreign banks 2003-2010



Q Do you envisage foreign banks making further acquisitions in China over the next three years?

The majority of foreign banks believe that they will not make acquisitions over the next three years.

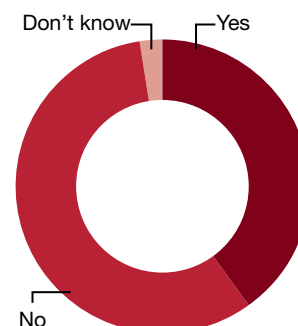
However, 16 banks believe the foreign banks will continue to acquire other financial institutions.

Some of the areas where acquisitions will be made include :

- securities firms
- trust companies
- city and regional banks
- leasing companies
- factoring companies
- insurance companies and
- asset management companies

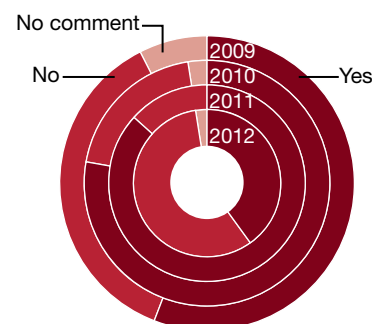
Those who thought acquisitions had come to an end cited a lack of capital, less options and excessive prices.

Further acquisitions by foreign banks



Based on responses from 40 banks

Interest in acquisitions by foreign banks 2009-2012



Companies To Issue Yuan Bonds Offshore

Chinese authorities may allow financial leasing companies to issue yuan bonds offshore, as they move to support the leasing industry, a National Development and Reform Commission official said Thursday.

Leasing for anything from aircraft to capital machinery is relatively under-developed in China, where the financial landscape is dominated by state-owned banks. But NDRC deputy director Zhang Xiaoqiang, speaking at a forum, said the leasing

industry is important for infrastructure investment and the high-technology sector. He referenced a State Council statement Wednesday which pledged support for seven strategic industries, including that of renewable energy involving solar and wind power, as well as of biotechnology and new materials. Leasing arrangements can help channel financing into these industries and encourage private-sector investment, Zhang said.

Source: Wall Street Journal, 31 May 2012

Beijing Loosens Some Foreign Ownership Limits

Beijing has agreed to allow foreign firms to own significantly larger, but still minority, stakes in Chinese brokerage firms, a small but long-awaited breakthrough in a sector in which restrictions have limited foreign firms.

At the conclusion of annual high-level talks between Chinese and U.S. officials Friday, a statement from the U.S. said China had agreed to allow foreign firms to own as much as 49% of joint ventures involved in securities underwriting. Foreign companies currently are limited to a 33% stake in such firms.

Limits on participation in China's financial markets have long been a source of frustration for foreign firms, which see themselves as

missing out on potentially lucrative opportunities as the financial needs of companies and individuals in the world's second-largest economy increase. Still, China says it is in compliance with the promises it made when it joined the World Trade Organization to open its financial sector to overseas competition.

The U.S. statement said foreign firms would be allowed to take a 49% stake in commodity and financial-futures firms, which a U.S. official previously said had ambiguous ownership restrictions.

"We welcome this policy change, which we believe will create new business momentum and help further enhance China's securities industry and capital markets," said a spokeswoman in China for Morgan Stanley, one of the roughly 10 foreign firms with securities joint ventures in China. Rules for foreign

insurance companies, fund-management firms and trust companies remain unchanged.

Both U.S. and European business groups repeatedly have lobbied Beijing to remove investment restrictions. In a statement distributed to Chinese government ministries in advance of Vice President Xi Jinping's visit to the U.S. in February, the U.S.-China Business Council, which represents the interests of some of the biggest U.S. firms in China, called on China to reduce or eliminate "foreign investment equity ownership limits in key financial services sectors, including domestic commercial banks, securities firms, and insurance and asset management companies."

Source: Wall Street Journal, 4 May, 2012

Q What is your bank's primary method of expansion in China?

The primary method of expansion for foreign banks in China continues to be organic growth. Thirty seven of the 41 respondents selected this option.

In addition six banks selected acquisitions, four banks chose joint ventures and one which is just establishing a presence a greenfield set-up.

Two articles on the following page provide an illustration of how foreign banks hope to broaden their representation and grow in China.

Q How do the foreign banks differentiate their services versus the domestic banks? Are foreign banks moving up the scale on product development?

In response to how foreign banks differentiate their wealth management services in relation to the domestic banks, they mention terms such as

- greater professionalism
- wider product knowledge
- a customer-centric service
- international experience
- relationship managers trained overseas
- international brand
- best in class product selection

- planning orientation
- value solutions and
- tailor made products

They however point out that for onshore wealth management products, it is challenging for the foreign banks to be innovative and creative. They are however able to offer clients a high quality service.

Participants acknowledge that domestic banks are improving and cite China Merchants Bank as a formidable competitor.

Q Can you identify any regulatory changes that would facilitate foreign banks expanding in the wealth management segment?

Regarding regulatory changes that would allow wealth management to expand, most participants identified the need for the regulator to relax restrictions on the breadth of scope of products.

Foreign banks would like to be able to broaden their product lines. Unit trusts are an obvious area.

In 2011, both HSBC and ANZ Bank were granted approval to trade gold futures on the Shanghai Futures Exchange.

Several foreign banks are members of the Shanghai Gold Exchange including Standard Chartered Bank, Bank of Nova Scotia, U.O.B., Credit Suisse, Barclays Bank and JP Morgan.

It is envisaged that the opening up of the RMB market, foreign exchange controls and interest rate controls, will all contribute to a major step forward in the provision of wealth management products.

ANZ Bank investing \$A300m to expand China network

Australia and New Zealand Banking Group, Australia's third-largest lender, plans to invest \$A300 million to expand its branch network and increase lending in China, the world's second-biggest economy.

ANZ was the first Australian bank to invest in China and has six outlets in Beijing, Shanghai, Chongqing and Guangzhou. It plans to increase its network to 20 outlets over the next 10 years, subject to regulatory approval. The capital follows an initial investment of \$A395m.

Source: National Business Review May 16, 2012

DBS invests to grow business

Singapore's DBS Bank will inject another 2.3 billion yuan (US\$363.5 million) into its Chinese subsidiary to accelerate its expansion in China.

The bank will invest the money to expand its network, hire more employees, upgrade infrastructure, enhance consumer and corporate Internet banking platforms as well as in technology improvement.

Source: China Daily, 12 April, 2012

JPMorgan injects \$400 mln into China unit, eyes expansion

JPMorgan Chase & Co has injected 2.5 billion yuan (\$394.08 million) into its China unit, the latest foreign bank to beef up its Chinese operations.

Foreign banks, including HSBC and Singapore's DBS Group, have either injected or are planning to pump in capital into their China units which are expected to grow rapidly over the coming years even as growth in the world's second-biggest economy comes off the boil.

"The additional capital will better position the bank in the evolving regulatory environment and cement our commitment to clients in China," Zili Shao, Chairman and chief executive of J.P. Morgan China, said in a statement on Monday.

Source: Reuters, 28 May, 2012

Bank of Montreal buys stake in Chinese firm Cofco

Plan to capitalize on growing middle class in Asia wanting to invest money globally

Bank of Montreal is expanding further into wealth management in China, making its second acquisition in the region in just over a year as it courts rich investors in Asia.

The Toronto-based bank is acquiring a 19.99 per cent stake in Cofco Trust Co., a state-owned investment firm that manages \$5.7-billion (U.S.) in assets.

It is the second wealth management deal in 13 months for BMO after the bank purchased Hong Kong-based Lloyd George Management, which manages about \$6-billion in assets throughout Asia, in January last year.

Source: Globe and Mail, 20 February, 2012

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Previous experience has shown that personal interviews with senior bankers using a standard questionnaire offers the best research approach. The questionnaire contained 51 questions and was completed during interviews of approximately one hour. The author conducted all interviews in April and May 2012 in Beijing, Hong Kong, Shanghai and Shenzhen.

Responses have not been attributed to individual banks but rather collectively within three groups: Asian banks (12), European banks (21) and North American banks (8). A group of locally incorporated banks is also used.

At times, individual banks declined to answer particular questions or were unable to provide sufficiently accurate data. This is noted where applicable.

The time commitment and support by all banks in this survey was outstanding.

About the author

Dr Brian Metcalfe is an Associate Professor in the Business School at Brock University, Ontario, Canada. He has a doctorate in financial services marketing and has researched for and produced many reports, such as this one, on behalf of PwC firms in 14 different countries including Australia, Canada, China, India, Japan and South Africa.

Previous reports have examined strategic and emerging issues in corporate, investment and private banking, life and property and casualty insurance, insurance broking, and wealth management.

In 2011, he authored the reports on Foreign Banks in China, Foreign Fund Management Companies in China and Foreign Insurance Companies in China.

He has consulted for a wide range of organisations, including Royal Bank of Canada, Scotiabank, Barclays Bank, Sun Life Insurance Company, Equitable Life of Canada and several major consulting firms.

He has also taught an executive management course entitled “Financial Services Marketing” in the Graduate School of Business at the University of Cape Town.

Bank groups

The information provided has been considered proprietary and remains confidential. Results are therefore presented in a “disguised” group format, in the form of regional bank groupings. The members of the bank groups are as follows:

Asian banks

- ANZ[†]
- Commonwealth Bank of Australia[†]
- Dah Sing Bank
- DBS Bank
- First Sino Bank
- Hang Seng Bank
- Mizuho Corporate Bank
- National Australia Bank[†]
- OCBC Bank
- The Bank of East Asia
- Westpac Bank[†]
- Wing Hang Bank
- HSBC
- ING Bank
- Intesa Sanpaolo Bank
- KBC Bank
- Natixis
- Nordea
- Norddeutsche Landesbank
- Rabobank
- Raiffeisen Bank International
- Société Générale
- Standard Chartered Bank
- UBS
- VTB Bank^{*}

European banks

- Banco Santander
- Barclays Bank
- BBVA
- BNP Paribas
- Crédit Agricole
- Commerzbank
- Credit Suisse
- Deutsche Bank

North American banks

- Bank of America Merrill Lynch
- Bank of Montreal
- Bank of New York Mellon
- Citibank
- JPMorgan Chase Bank
- Royal Bank of Canada
- Scotiabank
- Wells Fargo Bank

[†] ANZ Banking Group, Commonwealth Bank of Australia, NAB and Westpac Bank are Australian banks and for convenience have been grouped with the Asian banks.

^{*} VTB Bank is based in St Petersburg, Russia and has been included in the European banks.

List of locally incorporated foreign banks

Bank	
1	Allied Commercial Bank
2	Australia and New Zealand Banking Group
3	Bangkok Bank (China) Company Limited
4	Bank International Ningbo
5	Bank of East Asia (China) Limited
6	Bank of Montreal (China) Company Limited
7	Bank of Tokyo-Mitsubishi UFJ (China) Limited
8	BNP Paribas (China) Limited
9	Chinese Mercantile Bank
10	Citibank (China) Company Limited
11	CITIC Ka Wah Bank (China) Limited
12	Concord Bank
13	Crédit Agricole CIB (China) Limited
14	Dah Sing Bank (China) Limited
15	DBS Bank (China) Limited
16	Deutsche Bank (China) Company Limited
17	East West Bank (China) Limited
18	First Sino Bank
19	GE Capital Finance (China) Company Limited
20	Hana Bank (China) Company Limited
21	Hang Seng Bank (China) Limited
22	HSBC Bank (China) Company Limited
23	Industrial Bank of Korea (China) Limited
24	JPMorgan Chase Bank (China) Company Limited
25	KEB Bank (China) Company Limited
26	Metrobank (China) Limited
27	Mizuho Corporate Bank (China) Limited
28	Morgan Stanley Bank International (China) Limited
29	Nanyang Commercial Bank (China) Limited
30	OCBC Bank (China) Limited
31	Royal Bank of Scotland (China) Company Limited
32	Shinhan Bank (China) Limited
33	Societe Generale (China) Limited
34	Standard Chartered Bank (China) Limited
35	Sumitomo Mitsui Banking Corporation (China) Limited
36	United Overseas Bank (China) Limited
37	Wing Hang Bank (China) Limited
38	Woori Bank (China) Limited
39	Xiamen International Bank
40	Zhengxin Bank Company Limited

Participants by country/territory of origin

Name of bank	Country/Territory	City
ANZ	Australia	Shanghai
Commonwealth Bank of Australia	Australia	Shanghai
National Australia Bank	Australia	Shanghai
Westpac Bank	Australia	Beijing
Raiffeisen Bank International	Austria	Beijing
KBC Bank	Belgium	Shanghai
HSBC	Britain	Shanghai
Barclays Bank	Britain	Shanghai
Standard Chartered Bank	Britain	Shanghai
Bank of Montreal	Canada	Beijing
Scotiabank	Canada	Hong Kong
Royal Bank of Canada	Canada	Beijing
BNP Paribas	France	Shanghai
Crédit Agricole	France	Shanghai
Natixis	France	Shanghai
Société Générale	France	Shanghai
Commerzbank	Germany	Shanghai
Norddeutsche Landesbank	Germany	Shanghai
Deutsche Bank	Germany	Shanghai
Bank of East Asia	Hong Kong	Shanghai
Dah Sing Bank	Hong Kong	Shenzhen
Hang Seng Bank	Hong Kong	Shenzhen
Wing Hang Bank	Hong Kong	Shenzhen
Intesa Sanpaolo Bank	Italy	Shanghai
Mizuho Corporate Bank	Japan	Shanghai
ING Bank	Netherlands	Shanghai
Rabobank	Netherlands	Shanghai
VTB Bank	Russia	Shanghai
DBS Bank	Singapore	Shanghai
OCBC Bank	Singapore	Shanghai
Banco Santander	Spain	Shanghai
BBVA	Spain	Beijing
Nordea	Sweden	Shanghai
Credit Suisse	Switzerland	Beijing
UBS	Switzerland	Beijing
First Sino Bank	Taiwan	Shanghai
Bank of New York Mellon	USA	Shanghai
Citibank	USA	Shanghai
Bank of America Merrill Lynch	USA	Shanghai
JPMorgan Chase Bank	USA	Beijing
Wells Fargo Bank	USA	Shanghai

Top 50 Chinese banks ranked by Tier 1 capital and assets

Rank			Tier 1 Capital \$m	% change	Assets \$m	Rank
China	World					
1	6	Industrial and Commercial Bank of China	113,393	24.44	2,032,196	1
2	8	China Construction Bank Corporation	95,834	33.13	1,632,313	2
3	9	Bank of China	94,579	28.37	1,579,396	3
4	14	Agricultural Bank of China	79,285	59.97	1,560,905	4
5	35	Bank of Communications	34,321	51.67	596,674	5
6	60	China Merchants Bank	19,324	49.46	362,769	6
7	64	Shanghai Pudong Development Bank	18,222	88.77	330,894	7
8	66	China Citic Bank	17,994	18.61	314,270	8
9	73	China Minsheng Banking Corp	15,626	20.20	275,377	10
10	83	Industrial Bank	13,487	61.29	279,293	9
11	101	China Everbright Bank	11,529	69.54	223,464	11
12	144	China Guangfa Bank	6,438	104.58	122,969	13
13	145	Bank of Beijing	6,398	19.07	110,712	14
14	171	Huaxia Bank	5,206	20.27	157,070	12
15	179	Shenzhen Development Bank	4,971	70.93	109,866	15
16	194	Bank of Shanghai	4,336	44.50	85,581	16
17	226	Bank of Jiangsu	3,417	55.56	64,997	17
18	232	Chongqing Rural Commercial Bank	3,308	155.45	43,116	19
19	235	Shanghai Rural Commercial Bank	3,262	91.85	37,950	24
20	273	Bank of Nanjing	2,775	56.49	33,445	25
21	279	China Zheshang Bank	2,716	113.29	32,813	27
22	300	Ping An Bank	2,368	12.97	38,621	23
23	302	Bank of Ningbo	2,350	72.52	39,753	22
24	305	Evergrowing Bank	2,300	53.83	41,391	20
25	315	Huishang Bank	2,168	26.12	31,555	29
26		HSBC Corp (China)	1,970	10.08	31,048	30
27	342	Beijing Rural Commercial Bank	1,934	67.47	50,040	18
28	343	Guangzhou Rural Commercial Bank	1,930	24.14	31,931	28
29	354	Bank of Suzhou	1,867	564.70	8,158	66
30		Bank of East Asia China	1,812	11.15	23,107	35
31	374	Bank of Hangzhou	1,752	19.58	32,831	26
32	391	Bank of Jilin	1,615	41.76	22,360	37
33	400	Bank of Tianjin	1,593	35.77	30,724	31
34		Bank of Tokyo-Mitsubishi UFJ (China)	1,504	30.01	15,248	47
35	430	Chengdu Rural Commercial Bank	1,447	24.67	23,929	34
36	437	Bohai Bank	1,403	82.85	40,027	21
37	439	Bank of Guangzhou	1,386	13.84	25,238	33
38	445	Bank of Chengdu	1,361	19.46	22,849	36
39		Sumitomo Mitsui Banking Corporation (China)	1,361	7.73	9,730	57
40	455	Shunde Rural Commercial Bank	1,322	16.17	18,083	43
41	457	Bank of Jinzhou	1,300	75.59	14,150	48
42	489	Tianjin Rural Commercial Bank	1,189	50.15	20,088	39
43	490	Dongguan Rural Commercial Bank	1,168	16.94	19,187	42
44		Citibank China	1,149	15.84	19,237	40
45		Mizuho Corporate Bank (China)	1,130	58.44	9,374	62
46	506	Bank of Dalian	1,114	23.63	26,086	32
47	545	Bank of Kunlun	981	116.15	12,472	52
48	546	Hankou Bank	978	75.18	16,876	44
49	551	Jiangnan Rural Commercial Bank	959	13.16	20,294	38
50	555	Shenzhen Rural Commercial Bank	940	21.02	13,576	49

Source: The Banker, July 2011

Background comments on participants

Asian bank group

Asian banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
ANZ Bank 500 employees www.anz.com	45	45	2	Headquartered in Melbourne, ANZ operates in more than 32 countries. With assets of A\$532 billion, ANZ has around eight million personal, private banking, small business, corporate, institutional, and asset finance customers worldwide. ANZ has had a continuous presence in mainland China since 1986 when a representative office was established in Beijing. Locally incorporated in 2010, it is the only Australasian-based bank with both local and foreign currency commercial banking capabilities in mainland China. In March 2011 ANZ China opened a new branch in Chongqing, which brings the total number of its branches to four. ANZ also has long-term strategic partnerships with Bank of Tianjin (20% stake) and Shanghai Rural Commercial Bank (19.9% stake).
Commonwealth Bank of Australia 24 employees www.commbank.com.au	52	42	4	The Commonwealth Bank was founded in 1911 and now headquartered in Sydney, Australia. Between 1920s and the end of 1950s, it functioned as both a commercial bank and a central bank. At the end of 2010, the Group has A\$650 billion assets. Its first Chinese representative office was established in Beijing in 1994. It opened its first Chinese branch in Shanghai in March 2010. In addition, it owns 20% stake in two domestic banks, both Qilu Bank and Bank of Hangzhou respectively.
Dah Sing Bank 250 employees www.dahsing.com	509	483	11	Dah Sing Banking Group Limited has been listed on the Hong Kong Stock Exchange since 2004. Majority owned by Dah Sing Financial Holdings Limited, it has four banking subsidiaries (Dah Sing Bank, MEVAS Bank, Banco Comercial de Macau and Dah Sing Bank (China) Limited), a securities trading company, as well as an offshore joint venture private banking business with SG Hambros Bank. Dah Sing Bank is the strategic investor holding a 20% interest in Bank of Chongqing, which is a leading city commercial bank in Chongqing, the largest city in Western China. Bank of Chongqing is operating mainly in Chongqing with a branch network of 90 branches.

† The background comments were taken from the respective banks' websites in May 2012

Asian bank group

Asian banks	World ranking The Banker, July 2009		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
DBS Bank 2,000 employees www.dbs.com	57	91	1	Singapore-based DBS Bank is a leading financial services group in Asia that operates in 15 markets including China. It first entered the Chinese market with a representative office in Beijing in 1993. In May 2007, DBS Bank became the first Singapore bank to incorporate in China. In less than three years, DBS Bank (China) has increased its number of customers by four times and doubled its employees hired. Other than the head office in Shanghai, DBS Bank now has ten branches and 15 sub-branches in mainland China.
First Sino Bank 600 employees www.fsbankonline.com	N/A	N/A	N/A	Established in 1997 as the first joint venture bank between Taiwanese investors and a Chinese bank, First Sino Bank is headquartered in Shanghai with a registered capital of RMB1.1 billion. Its shareholders include Hong Kong-registered Lotus Worldwide Limited, Shanghai Pudong Development Bank and Wing Hang Bank. The major shareholders of Lotus Worldwide are Taiwanese investors. First Sino Bank also has branches in Tianjin, Shenzhen and Shanghai, plus ten sub-branches across the country.
Hang Seng Bank 1,800 employees www.hangseng.com	N/A	N/A	N/A	Hang Seng Bank is a principal member of HSBC Group, which holds a 62.14% equity stake in the bank. It offers personal, commercial and corporate banking services. Hang Seng (China) Limited was established on 28 May 2007 as a wholly-owned subsidiary of Hang Seng Bank, and operates a network of 12 branches and 29 sub-branches in mainland China.
Mizuho Corporate Bank 1,346 employees www.mizuhocbk.co.jp * Mizuho Financial Group	17*	11	3	Headquartered in Tokyo, Mizuho Bank was established on April 1, 2002 by Mizuho Financial Group Inc. Mizuho Bank has branches in Asia, Europe, the Americas and the Middle East. About 25 million individual customers have accounts with Mizuho Bank, and it has loans outstanding to roughly 100,000 SMEs and middle-market corporations. Mizuho Corporate Bank China, 100% owned by the Japanese parent, commenced operations in June 2007 in Shanghai with a current registered capital of RMB 6.5 billion. It is locally-incorporated in China with 12 outlets.
National Australia Bank 17 employees www.nab.com.au	39	37	1	National Australia Bank Group is a financial services organization with over 12,000,000 customers and 50,000 people, operating more than 1,750 stores and Service Centres globally. Its major financial services franchises in Australia are complemented by businesses in New Zealand, Asia, the United Kingdom and the United States. NAB established a representative office in Beijing in 1982 and opened a branch in Shanghai in November 2011.

† The background comments were taken from the respective banks' websites in May 2012

Asian bank group

Asian banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
OCBC Bank 800 employees www.ocbc.com.sg	84	97	2	Singapore-based OCBC Bank offers both consumer and business banking services through 500 branches and representative offices in 15 countries. OCBC Bank has maintained a continuous presence in China since 1925, with the opening of its first branch in Xiamen. On 1 August 2007, OCBC Bank opened its locally-incorporated, wholly-owned subsidiary in Shanghai, with a registered capital of RMB 3.5 billion. OCBC China now has 16 branches across the country.
The Bank of East Asia 4,000 employees www.hkbea.com	196	186	4	Founded in Hong Kong in 1918 and locally incorporated in mainland China in 2007, The Bank of East Asia (BEA) is the largest independent bank in Hong Kong, with consolidated assets of HK\$534.2 billion at the end of 2010. BEA operates over 140 outlets in Hong Kong and over 100 outlets within China, offering both retail and commercial services. BEA has an international network of more than 210 outlets and over 11,000 employees with a presence in US, UK, Canada, and Southeast Asia. Headquartered in Shanghai, BEA China set up its first branch in China in 1920 and has been operating continuously in the country ever since.
Westpac Bank 47 employees www.westpac.com.au	48	39	3	Westpac Bank began trading in 1817 in Sydney. Westpac Bank employs approximately 38,000 people worldwide and has global assets of \$670 billion. It has maintained a presence in Hong Kong since 1971 and mainland China since 1982. Its first branch in China opened in 2008 in Shanghai. It offers services including Corporate and institutional banking, foreign exchange and treasury. In 2008 Westpac Bank merged with St. George Bank to become Australia's leading provider of home lending, with a market share of 25 per cent, Australia's largest wealth manager with funds under administration of \$108 billion and the largest bank by market capitalisation at approximately A\$61.6 billion.
Wing Hang Bank xxx employees www.whbhk.com	480	431	10	Wing Hang Bank (WHB) was founded in Guangzhou as a money changing business in 1937 and has operated in Hong Kong for the past 70 years. WHB now has over 70 branches and representative offices throughout Hong Kong, Macau and Mainland China. The principal activities of the bank are retail banking, corporate banking and foreign exchange and treasury services. In June 2007 WHB established its local incorporation in mainland China, and it is the first foreign bank headquartered in Shenzhen.

† The background comments were taken from the respective banks' websites in May 2012

European bank group

European banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
Banco Santander 25 employees www.santander.com * Santander Central Hispano	13	16	1	Headquartered in Spain, Banco Santander is the fourth largest bank in terms of profit in 2009. Santander operates mainly in Continental Europe, the United Kingdom and Latin America. It opened the first Chinese representative office in Beijing in 1993. Santander already has an agreement with China Construction Bank to set up a joint venture village bank, in which Santander will have 20% stake.
Barclays Bank 30 employees www.Barclays.com	12	5	3	Barclays is a major global financial services provider engaged in personal banking, credit cards, corporate and investment banking and wealth and investment management with an extensive international presence in Europe, the Americas, Africa and Asia. Headquartered in London, UK and with over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs 140,000 people.
BBVA 30 employees www.bbva.com	28	35	2	BBVA is a global group that offers individual and corporate customers a range of financial and non-financial products and services. It employs 104,000 people in over 30 countries around the world, and has more than 47 million customers and 900,000 shareholders. BBVA has a solid position in the Spanish market, where it first began its activities over 150 years ago. It also has a leading franchise in South America and it is the largest financial institution in Mexico. BBVA owned 4.93% stake of China Citic Bank, which is the seventh largest financial entity in China by assets. In 2009 BBVA raised its stake to 15%.
BNP Paribas 300 employees www.bnpparibas.com	11	1	1	BNP Paribas is a global banking and financial services group that is present in 80 countries. The group operates in three major segments: Corporate and Investment Banking, Investment Solutions and Retail Banking. In October 2005, BNP Paribas signed an agreement to buy 19.2 percent of Bank of Nanjing (BON) and now holds 12.6 percent. In June 2008, it converted the branches of BNP Paribas in Beijing, Tianjin and Guangzhou into branches of its existing local subsidiary, BNP Paribas (China) Limited, which is now headquartered in Shanghai.
Crédit Agricole 200 employees www.ca-cib.com * Crédit Agricole Group	15*	6	2	With a network of more than 54 million customers globally and 160,000 staff in 70 countries, Crédit Agricole specialises in capital markets, investment banking and financing. It earned 35.1 billion Euros revenue in 2011. Building on over a century of activity in China, Crédit Agricole has five fully operational branches in Shanghai, Beijing, Guangzhou, Tianjin, Xiamen and a representative office in Shenzhen. Crédit Agricole China was among the first foreign banks to be licensed for Chinese currency (renminbi) operations.

† The background comments were taken from the respective banks' websites in May 2012

European bank group

European banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
Commerzbank 108 employees www.commerzbank.com	29	26	2	Commerzbank is the second largest credit institution in Germany, with the merging of Dresdner Bank into Commerzbank in May 2009. It has a total of around 14 million private and corporate customers worldwide and assets of 662 billion Euro. In China, Commerzbank now has three branches in Shanghai, Beijing and Tianjin.
Credit Suisse 60 employees www.csfb.com	31	25	1	Credit Suisse Group is a global financial services company headquartered in Zurich. Founded in 1856, Credit Suisse serves companies, institutional clients and high-net-worth private clients worldwide. Credit Suisse is active in over 55 countries and employs about 48,700 people from approximately 100 different nations. The Company provides its clients with a range of products and services that include Investment Banking, Private Banking and Asset Management.
Deutsche Bank 500 employees www.china.db.com	21	2	1	Founded in Berlin in 1870, Deutsche Bank is a global investment bank, employing over 100,000 people in 70 countries. Deutsche Bank first established its presence in 1872 in Shanghai. Deutsche Bank in China and Hong Kong now has business interests in corporate advisory and capital markets, transaction banking, private and retail banking, as well as asset management in China and Hong Kong. Deutsche Bank also has a retail presence in China, acquiring a 19.99 percent stake in Hua Xia Bank. Deutsche Bank has locally incorporated and headquartered in Beijing in January 2008. It now has branches in Beijing, Shanghai, Guangzhou, Tianjin and Chongqing.
HSBC 5,700 employees www.hsbc.com.cn	3	4	1	Established in Hong Kong and Shanghai in 1865, HSBC operates around 7,200 offices in over 80 countries and territories. HSBC Bank (China) Company Limited began operations on April 2, 2007 as a wholly-owned subsidiary of The Hong Kong and Shanghai Banking Corporation Limited. HSBC has had a continuous presence in mainland China for 147 years. It has invested over US\$7 billion in selecting mainland financial services entities, including the acquisitions of a 19% stake in Bank of Communications, a 15.57% stake in Ping An Insurance, and an 8% stake in Bank of Shanghai. Its current network in mainland China comprises of 117 outlets. It was the first foreign bank in China to engage in gold-exchange business. HSBC China also offers debit cards that can link a renminbi account and up to two foreign currency accounts.
ING Bank 60 employees www.ing.com	24	13	1	ING is a global financial institution providing banking, investments, life insurance and retirement services for its customers. ING Group serves more than 85 million customers in Europe, the US, Canada, Latin America, Asia and Australia. ING expanded into retail banking through its acquisition of a 16.07% stake in the Bank of Beijing. ING is active in lending, financial markets and corporate finance in China. It also operates its private banking services out of Hong Kong.

† The background comments were taken from the respective banks' websites in May 2012

European bank group

European banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
Intesa Sanpaolo Bank 31 employees www.intesasnpaolo.com	30	28	2	Intesa Sanpaolo is an Italian banking group resulting from the merger of Banca Intesa and Sanpaolo IMI. In addition to its operations in the Italian market it has an international presence focused on Central-Eastern Europe and the Mediterranean basin. With total assets of 639 billion Euros, it serves 10.8 million customers and has more than 5,600 branches worldwide. In 2007, Intesa Sanpaolo acquired a 19.9% stake in Bank of Qingdao, a local commercial bank in Shandong Province.
KBC Bank 53 employees www.kbc.com	53	55	3	Established in 1935, KBC is a bank and insurance company in Belgium. It operates in some 30 countries with over 2,200 branches among which corporate banking subsidiaries are located in Germany, the Netherlands, Ireland, the UK, the US, France, China, Hong Kong and Singapore. KBC's Shanghai branch operation was established in May 1997.
Natixis 44 employees www.natixis.fr * Groupe Banques Populaire	22*	21	3	Natixis is the listed subsidiary of the Banque Populaire Group and Caisse d'Epargne Group. Natixis is a French-based financing, investment banking and services bank with over 20,000 employees and 116 offices in 68 countries. Natixis' network specialises in these areas: corporate and investment banking, asset management, private equity and private banking, services as well as receivables management. It has a branch in Shanghai and a representative office in Beijing.
Norddeutsche Landesbank 30 employees www.nordlb.de	104	71	7	Norddeutsche Landesbank (NORD/LB) has representations and service offices worldwide and a network of more than 1,500 correspondent banks and 6,463 employees plus a consolidated balance sheet of 228 billion Euros as at the end of 2011. It offers a wide range of financial services to its private, corporate and institutional clients and to the public sector. The main areas of specialisation of NORD/LB are investment, agricultural and real estate banking, corporate finance, ship and aircraft financing as well as private banking. It has a branch in Shanghai and a representative office in Beijing.

† The background comments were taken from the respective banks' websites in May 2012

European bank group

European banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
Nordea 22 employees www.nordea.com	42	33	1	Nordea Bank AB is a Stockholm-based financial services group operating in Northern Europe. The bank is the result of the successive mergers and acquisitions of several banks in the region. Nordea has around 11 million customers, approx. 1,400 branch offices and is among the ten largest universal banks in Europe in terms of total market capitalisation. Nordea is the largest financial services group in Northern Europe with a market capitalisation of approximately EUR 28bn and total assets of EUR 694bn.
Rabobank 60 employees www.rabobank.com	27	29	2	Rabobank is a full-range financial services provider founded on cooperative principles. Rabobank Group is comprised of 152 independent local Dutch Rabobanks plus Rabobank Nederland, their central organisation, and a number of subsidiaries. Food and agribusiness is the main focus of Rabobank. It actively expanded its Chinese business into agriculture, food processing, communications and environmental sectors through its offices in Shanghai and Beijing. It also has a rural banking presence. In 2006, Rabobank acquired a 10% stake in United Rural Cooperative Bank of Hangzhou, which became Hangzhou United Bank in January 2011, with 136 outlets and ten million customers.
Raiffeisen Bank International 100 employees www.rzb.at	90	99	3	With a balance sheet of 147 billion Euros as at 31 December 2011, Raiffeisen Zentralbank Österreich AG (RZB) is the third-largest bank in Austria. RZB was founded in 1927 and is headquartered in Vienna. In addition to operations in Austria and Central and Eastern Europe, RZB is also active in a number of international centres. Raiffeisen Bank International AG (RBI) originated from the merger of Raiffeisen Zentralbank Österreich AG's (RZB) principal business areas and Raiffeisen International Bank. Within China, RBI offers services to retail and corporate customers, as well as financial institutions and sovereigns. It has branches in Beijing and Xiamen, and representative offices in Zhuhai, Harbin and Hong Kong. It also has a finance company in Hong Kong.

† The background comments were taken from the respective banks' websites in May 2012

European bank group

European banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
Société Générale 650 employees www.societegenerale.com	26	20	4	Société Générale dates back to 4 May, 1864, the date of the authorisation decree signed by Napoleon III. Société Générale Group serves more than 33 million customers in France and worldwide. Its international retail banking division is present in 37 countries. The corporate and investment banking division of the Société Générale Group operates in over 41 countries across Europe, the Americas and Asia Pacific, and employs around 12,000 staff worldwide. Société Générale opened a representative office in Beijing in 1981. Société Générale China received final regulatory approval for local incorporation to set up a wholly foreign owned bank in China in August 2008. Societe Generale (China) Limited began operations in September 2008 and now has 8 outlets across the country. In China, its services include corporate and investment banking, commercial and personal banking as well as private banking.
Standard Chartered Bank 7,030 employees www.standardchartered.com	36	44	5	Standard Chartered has an extensive global reach. It has a network of over 1,700 branches and outlets in more than 70 countries across Asia, the Middle East, Africa, Europe and the Americas. Standard Chartered employs 85,000 people, representing 125 nationalities and derives over 90 per cent of its profits from the emerging trade corridors of Asia, Africa and the Middle East. In China, the Bank set up its first branch in Shanghai in 1858 and has remained in operation throughout the past 150 years. Standard Chartered Bank (China) Limited is one of the first foreign banks to locally incorporate in China in April 2007. Standard Chartered has one of the largest foreign bank networks – with 21 branches, 64 sub-branches and a Village Bank in China.
UBS 600 employees www.ubs.com	32	22	2	With headquarters in Zurich and Basel, Switzerland, UBS operates in over 50 countries and is present in all major international centres. UBS employs more than 65,000 people globally. It offers global wealth management and business banking, global asset management and investment banking services.
VTB Bank 21 employees www.vtb.com	67	122	2	VTB Group is the first international financial group of Russian origin representing Russia in global markets and providing professional financial services. In 2011, VTB Group, with assets of about RUB 6,790 billion, earned RUB 90.5 billion net profit and assets about RUB 6,790 billion. Presently, the Government of the Russian Federation is the major shareholder of VTB, with its share accounting for 75.5%. VTB works with foreign export insurance agencies and the Export-Import banks, including Export-Import Bank of China and the Industrial and Commercial Bank of China.

† The background comments were taken from the respective banks' websites in May 2012

North American bank group

North American banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
Bank of America Merrill Lynch 470 employees www.bankofamerica.com	1	8	1	Bank of America Merrill Lynch serves individual consumers, small and middle market businesses and large corporations with a range of banking, investing, asset management and other financial and risk-management products and services. Within the United States, it serves approximately 57 million consumer and small business relationships with 5,700 retail banking offices and approximately 17,750 ATMs.
Bank of Montreal 370 employees www.bmo.com	58	57	4	Bank of Montreal, Canada's first chartered bank, opened for business on 3 November 1817. With total assets of C\$538 billion as in January 2012 and almost 47,000 employees, BMO provides a broad range of retail banking, wealth management and investment banking products and solutions. It is currently active in Europe, Latin America, and East Asia as well as in the United States. BMO's history in China dates back to the early 1800s. BMO currently has branches in mainland China and Hong Kong, as well as a representative office in Taiwan and an investment banking representative office in Beijing.
BNY Mellon 140 employees www.bnymellon.com	82	83	15	Headquartered in New York and established in 2007 from the merger of Mellon Financial Corporation and The Bank of New York Company, Inc., BNY Mellon has US\$1.3 trillion assets under management and 49,000 employees in 36 countries worldwide. The company has had a physical presence in China since 1994 when it opened its first office in Shanghai, and later another in Beijing.
Citibank 6,000 employees www.citi.com	4	12	3	Citi is a US-based financial services company with some 200 million customer accounts in more than 160 countries. Citi's history in China dates back to 1902 when it became the first American bank to establish operations. Now Citi offers corporate and investment banking, consumer banking and private banking services. On 2 April 2007, Citi locally incorporated as Citibank (China) Company Limited. As of May 2012, Citi operates 61 outlets in China.

† The background comments were taken from the respective banks' websites in May 2012

North American bank group

North American banks	World ranking The Banker, July 2011		Home country ranking	Background comments†
	Tier 1	Assets	Tier 1	
JPMorgan Chase Bank 450 employees www.jpmorganchase.com	2	9	2	JPMorgan Chase & Co. is a US-based global financial services firm with assets of US\$2.3 trillion and operates in more than 60 countries with over 240,000 employees. JPMorgan's history in China dates back to the 1920s. It offers wholesale and commercial banking products. In July 2007, JPMorgan Chase Bank (China) locally incorporated, making it the first locally incorporated foreign bank in Beijing.
Royal Bank of Canada 22 employees www.rbc.com	37	36	1	RBC provides personal and commercial banking, wealth management services, insurance, corporate and investment banking services on a global basis. RBC employs more than 74,000 full and part-time employees who serve close to 15 million clients in Canada, the US and 56 other countries. RBC currently has operations in the mainland and Hong Kong.
Scotiabank 61 employees www.scotiabank.com	46	43	2	With approximately 77,000 employees, Scotiabank Group and its affiliates serve more than 19 million customers in more than 55 countries around the world. Scotiabank has been in China for more than 20 years. Its Chinese business includes loans, deposits, trade finance, cash management and treasury services. Scotiabank purchased a minority stake in Xi'an City Commercial Bank, an investment initiative undertaken jointly with the International Financial Corporation.
Wells Fargo Bank 77 employees www.wellsfargo.com	7	23	4	Wells Fargo opened for business in the gold rush era in San Francisco. It is now a diversified financial services company providing banking, insurance, investments, mortgage, and consumer and commercial finance through more than 9,000 stores and 12,000 ATMs and the Internet across North America and internationally. Wells Fargo has US\$1.3 trillion in assets and approximately 270,000 team members. It ranks fourth in assets and second in market value of its stock among other US peers as of March 31, 2012.

† The background comments were taken from the respective banks' websites in May 2012

American Chamber of Commerce White Paper – Bond Market Section April 2012

Introduction

AmCham China commends China's continued efforts to establish more open and transparent financial services markets and encourages Chinese regulators to initiate further bond market reforms to continue this positive momentum. The development of bond markets both government and corporate is an important part of the financial infrastructure and will contribute significantly to capital allocation efficiency and overall financial market expansion.

Fully functioning, open financial markets and efficient capital allocation depend on the strong foundation of a liquid and transparent government bond market in particular. The benefits of such government bond markets include: benchmark sovereign rates, necessary for pricing other instruments in a healthy financial system, including corporate bonds, bank loans, and derivatives; sound money markets; lower overall systemic risk within the financial system; cost-effective risk management; lower long-term government funding costs; and the development of an institutional savings sector, including pension funds.

In order to establish a strong government bond market, China will need to institute eight fundamental elements: (1) deregulated interest rates; (2) disciplined issuance/reissuance and retirement programs to support large, deep benchmark issuances; (3) a liquid "classic" bond repurchase (repo) market; (4) a liquid and active government bond futures market; (5) a broad range of liquid over-the-counter (OTC) derivatives contracts and exchange-traded derivatives contracts; (6) high quality, efficient, and cost effective electronic price discovery, trading, and settlement platforms; (7) market-friendly regulations and taxes; and (8) a broad and active domestic and foreign investor base. Most of these requirements are addressed below.

A lack of market-driven capital allocation, including a loan and deposit rate regime, and the absence of true national treatment for foreign-invested institutions in China's nascent bond markets especially with respect to underwriting, market making, derivatives trading with corporate clients, and bond settlement agent licensing remain significant obstacles to China's further progress. Detailed discussion follows of the technical aspects crucial to functioning government bond markets, the underlying prerequisites of sound financial markets in general, China's recent accomplishments with respect to bond market development, and other issues for further consideration.

Significant Developments Bond Volume Growth

Corporate and government bond volumes grew throughout 2011. Although China has become the largest corporate bond market in Asia, excluding Japan, corporate bonds still account for a relatively small portion of the total sector funding. At the end of 2011, China's interbank market bonds outstanding totaled approximately RMB 7.8 trillion (US \$1.24 trillion), consisting of RMB 1.7 trillion (US \$267.7 billion) in government bonds (21.8 percent), RMB 1.4 trillion (US \$220.5 billion) in central bank bills (17.9 percent), RMB 2.5 trillion (US \$393.7 billion) in financial institutional bonds (32.1 percent), and 2.2 trillion (US \$315 billion) in non financial corporate debt financing instruments (28.2 percent).

Underwriting

In 2011, the National Association of Financial Markets Institutional Investors (NAFMII) a People's Bank of China (PBOC) sponsored entity with characteristics including those of a quasi regulatory, self regulatory organization, a financial services holding company, and a trade

association was instrumental in designing a market oriented bond underwriting entry and exit mechanism through a process that included consultation with member committees. In principle, these new criteria should allow both local and foreign invested banks to underwrite bonds in China. This will help establish greater clarity and simplify the process for foreign invested bank participation as sub underwriters initially, and later as lead underwriters, for commercial paper (CP) and medium term note (MTN) bond markets.

However, in practice, as of late 2011, and despite the presence for many years in China of world leaders in bond underwriting, only one foreign invested bank has been granted underwriter status as part of this process. As described below in the Specific Issues section, the new criteria serve only as a first step toward developing an issuer driven underwriter selection and appointment process consistent with the approach taken in advanced financial markets.

Retiring and Reissuance Process

In leading government bond markets, typically multiple issues of similar maturities exist, of which the most actively traded in a given maturity is called an "on the run" issue. Government bond markets maintain on the run issues to meet buyer and seller demands by maintaining deep, liquid issues. The depth is created by consistently reissuing targeted existing issues and retiring illiquid existing issues. An effective bond market management strategy creates deep on the run benchmark issues of maturities across the yield curve and contributes to overall market liquidity.

We applaud the Ministry of Finance (MOF) for increasing reissuances in 2011 which created deeper benchmark on the run government bonds and improved liquidity at certain points along the yield curves. In addition, we

commend PBOC and MOF for publishing rules in April 2011, effective June 1, 2011, requiring market makers to show two way quotes on the four nearest issued government bonds for each benchmark tenor, a move that also enhances market liquidity.

A Broad Investor Base

Over the course of 2011, PBOC steadily increased to around 40 the number of foreign invested banks with limited individual quotas to invest directly in the over the counter (OTC) interbank bond market using offshore RMB funds, including one central bank as of November 2011. Though undisclosed, the size of the individual quotas is understood to remain modest; however, the aggregate sum is not insignificant. In December, the China Securities Regulatory Commission (CSRC), PBOC, and the State Administration of Foreign Exchange (SAFE) jointly announced a pilot program to allow RMB Qualified Foreign Institutional Investors (RQFIIs) to invest offshore RMB into mainland capital markets. By February 1, 2012, 21 RQFII licenses were reportedly issued with a combined total quota of RMB 20 billion (US \$3.17 billion). Of each RQFII's individual quota, at least 80 percent must be invested in fixed income products, including on the OTC interbank bond market. China should build upon this progress in creating greater access for foreign investors in China's markets, as described below in the Specific Issues section.

Specific Issues

AmCham China encourages China to use this positive momentum to eliminate the remaining impediments to bond market development and raise domestic bond markets to new levels of liquidity and efficiency.

National Treatment and Full Market Access for Foreign Owned Institutions

As a fundamental issue that relates directly to most if not all of the issues covered in this chapter, China should treat foreign invested and domestic banks and securities houses equally with regard to licensing, corporate form, regulation, and permitted products and services, allowing them to compete fully in domestic markets. Restricting national treatment impedes innovation, market development, and economic activity, among other things. Without providing such consistent and equal access to the marketplace, China remains vulnerable to increased criticism that its financial industry policies are protectionist and aimed at excluding foreign invested institutions from its financial markets. Fuller engagement by international financial services companies will contribute to the further development of Chinese domestic markets through the transfer of best practices.

In particular, significant restrictions exist with respect to setting up wholly foreign owned subsidiaries in China, and many financial sector businesses are required by regulation to enter into joint ventures with local partners and are subject to a limited scope of activity. Foreign invested firms hoping to expand activities and branch networks or offer new products also face a complex, slow, opaque, and often futile approval process. In addition to the expanded expertise and technology transfer that inevitably follow broader participation by foreign invested institutions, China's financial services industry development and global financial market integration will also be accelerated.

AmCham China urges China to grant foreign invested firms full national treatment and market access and to

maintain a level playing field for all businesses through efficient and transparent administrative processes.

Interest Rate Liberalization

China's primary bond markets are among Asia's largest, but the secondary markets are largely illiquid. Since PBOC currently sets interest rates through an administrative process, bonds are issued with coupons at negative real interest rates. China's controlled interest rate regime also distorts primary market underwriting, because risk cannot be properly priced and issues are little more than private placements. AmCham China suggests the gradual liberalization of interest rates so that active trading can develop in true secondary markets based on a robust yield curve. The resulting enhancement of debt capital markets will allow banks to establish a market culture better equipped to address credit risk and better positioned to allocate capital efficiently.

Market Driven Selection Process in Underwriting

Although foreign invested banks can trade CP and MTN on the OTC interbank market in China, they still have very limited access to the market for underwriting these issues. AmCham China commends NAFMII's attempts to resolve this issue by designing a more market oriented bond under writing entry and exit mechanism, as described above in the Significant Developments section. However, under NAFMII's current proposal, it will still take years of service as a sub underwriter in China and the meeting of additional criteria before a foreign invested bank can be eligible for full underwriter status.

In addition, while the draft qualitative and quantitative criteria give the appearance of being neutral, in practice these requirements will exclude many

foreign invested banks. In fact, the new rules, in addition to amounting in practical terms to protectionist measures, establish a system whereby the regulator sets criteria for underwriter selection, an approach in stark contrast to standard best practices applied to issuers in developed financial markets. In these mature markets, issuers select lead underwriters, and lead underwriters select sub underwriters with issuer approval based on commercial criteria, regardless of a bank's national origin. Foreign owned banks, including Chinese banks, are eligible to underwrite issues in developed economies across the world, notably in the US, UK, and elsewhere in the EU. In such jurisdictions, banks selected through a commercial process need only meet minimum standard requirements, such as holding a specific banking license, retaining qualified staff, or having appropriate risk management systems, in order to act as an underwriter.

Allowing experienced foreign invested banks into China's underwriting market will offer domestic issuers more choice and will lead to more cost effective options, lower funding costs, raised disclosure standards, and expanded distribution channels, particularly when lead underwriter status becomes available. The broader competition and cooperation among underwriters typical of leading global markets will improve the functioning of the Chinese market and raise the quality of service to clients.

Debt to Net Asset Ratio Limits

Although the corporate MTN and CP markets in China have continued to grow throughout 2011, the 40 percent debt to net assets ratio limit for a corporate to issue debt hinders the development of the corporate bond market. It limits the activities of

creditworthy corporate issuers, in turn diminishing the underwriting market and the transactions derived from the corporate credit market. Such a debt to net assets ratio limit is unusual in the context of disclosure based international bond markets. AmCham China encourages reconsideration of this limitation before it becomes a major impediment to the corporate bond market in China.

Retiring and Reissuance Process

Although China has made notable progress as described in the Significant Developments section above, China's government bond issuance program still lacks deep and liquid on the run benchmark bonds across the maturities spectrum, contributing to an uneven and inefficient yield curve. We encourage China to continue recent progress in increasing reissuances, and reinforce this activity through the targeted retiring of off the run government bonds. Such an approach would build market confidence in the consistent availability of such reference benchmarks, which in turn would enhance market liquidity in general.

Creditors' Rights and Bankruptcy Procedures

Overall, the rules governing creditors' rights in bankruptcy must be strengthened and improved in order to ensure market participant confidence in the enforceability of transactions and contracts. This is particularly important for those transactions and contracts related to repos, futures, and other derivatives typically traded under master agreements and often secured by collateral.

For example, under current Chinese bankruptcy law, an insolvency administrator has the right to decide whether to set aside or uphold any executory contract or disregard any

contractual termination rights. The exercise of this discretion is commonly referred to as "cherry picking."

Another problem has to do with the enforceability of closeout netting for repo and derivatives transactions between counterparties, which is addressed with legal certainty in most other financial markets. Globally, such transactions are generally traded under internationally recognized master agreements, such as the Global Master Repurchase Agreement or the International Swaps and Derivatives Association master agreements. Under these agreements, if one party to a repo or derivatives transaction goes bankrupt, all transactions documented between the parties under the relevant agreement will be terminated by netting all transactions under which funds are owed to or due from the counterparties. Through this approach, the amounts owed by and due to each of the parties under each and every relevant transaction are calculated, resulting in the payment of one net amount.

Under the current system in China, Chinese banks seem to rely on implicit government guarantees as the primary form of risk management when dealing with each other. This creates systemic risk and leaves the derivatives market dangerously exposed in the event a Chinese bank defaults and the government does not step in to cover the obligation. Foreign invested banks cannot rely on this implicit guarantee and as a result must reduce the capital they provide to the market.

Clarification through unambiguous legislation, written judicial interpretation, or administrative regulation on the enforceability of close out netting, the use of collateral, and the disapplication of cherry picking powers in the context of qualified financial contracts, would strengthen

Chinese domestic agreements. AmCham China encourages regulators to reinvigorate consideration and development of this or other stand alone regulations to resolve netting and cherry picking issues.

“Classic” Government Bond Repo Market

A “classic” bond repurchase (repo) market refers to a system within which margining of exposures is standard practice and the bond title is actually transferred as part of the agreement. This allows market participants to use the bonds they hold for additional purposes, such as further repos, covering short positions, securities lending, or collateral. As a result, the underlying bonds in classic repo agreements continue to generate market liquidity.

Although some progress has been made, a fully liquid and active classic repo market remains elusive in China. Repo transaction volumes grew throughout 2011 but remained relatively short term, with as much as 85 percent being pledged as security and involving no title transfer, meaning not functioning as true repos. The inability to manage collateral margins continues to inhibit the development of term repos (i.e., those longer than overnight). China’s bond market would be better served by a repo market that more closely mirrors the global best practices applied under the classic approach.

Chinese Master Repo Agreement

NAFMII took an important step toward development of a classic repo market in 2010 by producing an updated draft Chinese master repo agreement (CMRA). Once approved, the CMRA will support the further development of a classic repo market, including term repos, and also significantly facilitate repo negotiations.

AmCham China urges Chinese regulators to finalize the CMRA as soon as possible in 2012, as NAFMII’s document incorporates the classic repo approach and will dramatically enhance repo market development. Such a move would lay the foundation for a solid term repo market, extend liquidity across the government bond yield curve, and make more precise risk management hedging transactions possible.

Business Tax Rules

Other impediments to the development of a classic term repo market include accounting and tax rules. As China’s financial markets mature and transactions across the spectrum of repos, futures, interest rate derivatives, and bond trading become more interdependent, the failure of tax rules to keep pace with the industry creates concerns for domestic as well as foreign invested banks.

Business tax rules, which segregate transactions into four separate categories (foreign exchange, stocks/equities, bonds, and other), were developed long before financial markets reached their current level of sophistication. As the profit margins on the overall transactions are generally quite thin, the resulting gross tax on a transaction as a whole may be close to or even exceed the net profit, discouraging hedged transactions or relative value trading.

Administration of these business tax rules should be amended as soon as possible to eliminate the four transaction categories and allow net gains and net losses to be carried forward. This approach would reflect modern business practices and promote market liquidity. Although a value added tax pilot program was launched in January 2012 in Shanghai for specific industries, it may take years to

implement comprehensively. In the meantime, we urge that China address these business tax rule issues without further delay.

Government Bond Futures Market

An active, liquid, and closely supervised government bond futures market would allow participants to hedge positions quickly and reduce risk more effectively, while at the same time deepening the underlying bond and derivative markets in China.

Government bond futures markets are essential for the efficient functioning of market makers and primary dealers and are a key component of developed markets in general.

In early 2012, unconfirmed press reports indicated that the China Financial Futures Exchange had begun preparations for a pilot program to reintroduce the trading of government bond futures for a select group of financial firms, with a formal launch of the product anticipated by mid 2012. AmCham China welcomes this news and encourages China to re launch a government bond futures market with regulatory, supervisory, and technological infrastructure. The growth of a classic term repo market in China will also require the development of a government bond futures market.

A Broad Investor Base

The existence of a broad and active investor base with foreign investor participation generates market activity and liquidity. China’s effort to develop an offshore RMB market supports the expansion of a foreign investor base in the longer term and creates additional channels through which such investors can participate more meaningfully in the domestic bond market.

As described in the above Significant Developments section, PBOC made further progress in 2011 and early 2012 by increasing the number of foreign invested banks with limited individual quotas to invest directly in the OTC interbank bond market using offshore RMB funds and by initiating the RQFII scheme pilot program. China should continue this momentum by expanding and increasing the number of existing investment channels and increasing the size of, or eliminating altogether, investment quotas. At a minimum, increasing the size of quotas for direct investment in the OTC interbank bond market, starting initially with quotas of US \$30.5 billion (RMB 190.32 billion) for approved foreign investors, would be a step in the right direction.

Securitization Market

At present, China has a significant informal and unregulated securitization market, through which trust companies act as intermediaries between fund providers and borrowers. Well regulated and effective securitization markets are internationally recognized as efficient financing mechanisms. The establishment of a formal securitization market, with clear, consistent, and enforceable rules and sound documentation and disclosure requirements, would better address the concerns of banks, regulators, and investors. Further, it could be employed to aid government policy to promote low cost housing, among other things.

Regulatory Process and Notification

China's regulatory and jurisdictional uncertainty is a serious impediment for foreign invested financial institutions, effectively serving as a non tariff trade barrier. Regulatory transparency and consistency, market consultation processes, sufficient notification of new

rules, and time for public comment are vital to well functioning financial markets.

A large number of regulatory and quasi regulatory bodies govern the financial services sector in China (e.g., PBOC, SAFE, MOF, SAT, NDRC, CSRC, CBRC, CIRC, and NAFMII), each with its own priorities and processes. Notification of regulatory changes across these institutions is inconsistent, and the complex approval processes for new products or licenses continue to suffer from the absence of a coordinated regulatory approach. Also, rules are often unclear, reasons for denial or approval are not widely disclosed, and in some cases the rules themselves are not publicly available. At times it is not even clear which regulator's approval is required, and sometimes regulators themselves disagree about approval processes or procedures.

AmCham China urges regulators to establish a coordinated, clearly defined, and efficient regulatory process.

International Standard Commercial Practices

Additional limitations are imposed on the market by unusual incentive programs or other approaches to licensing that are not international standard practice. Two examples include Chinese market maker status and bond settlement agent licensing in derivatives trading.

Chinese Market Maker Status and Derivatives

Trading

Derivatives trading with corporate clients in China requires multiple regulator licenses and approvals, a privilege available on a very limited basis. One of the eligibility requirements is service as a PBOC approved market maker. In the world's

leading financial centers, market makers are financial institutions that offer two way pricing quotes to buyers and sellers for various products, currencies, or commodities. There is simply no rationale for linking derivatives trading with corporate clients to market maker status. In fact, this linkage impedes the growth and liquidity of the derivatives market. US, UK, and EU regulators do not require market makers to hold specific market maker licenses; however, in China, PBOC grants such status and offers derivatives trading privileges to offset the burdens of market making. AmCham China urges regulators to abandon this linkage.

Bond Settlement Agent Licensing and Derivatives Trading

The only other way to trade derivatives with corporate clients in China is to acquire a Level "A" Bond Settlement Agent License, also granted by PBOC. In 2011, two foreign invested banks succeeded in obtaining such licenses, and we appreciate this development. Nonetheless, clearer criteria and explanations for disqualifications would promote a better understanding of this process. Ultimately, AmCham China urges PBOC to allow participation by foreign invested banks in expanded derivatives trading.

Conclusion

China appears well positioned to use its positive momentum to address these issues and bring domestic bond markets in line with globally accepted and tested practices. This will allow harmonization between Chinese and international bond markets and move China firmly toward full capital account convertibility in the future. Significant progress has already been made, although further advancement continues to be hindered by discriminatory rules and policies that disadvantage foreign invested banks. AmCham China supports China's efforts to expand domestic bond markets in line with leading financial markets.

Recommendations

- Support national treatment for all banks and securities houses, including by allowing foreign invested banks to compete fairly and fully in domestic markets (particularly in the areas of underwriting and derivatives trading) and removing limits on foreign ownership in all financial services sectors. [PBOC, NAFMII, CBRC, CSRC, and State Council]
- Clarify creditors' rights through unambiguous regulations, legislation, or judicial pronouncements regarding the enforceability of close out netting, use of collateral, and elimination of cherry picking by insolvency administrators. [MOF, PBOC, CBRC, and CSRC]
- Develop a classic term repo market, including by amending existing regulations, business tax, and accounting rules that inhibit market development. [NAFMII, PBOC, MOF, CSRC, and SAT]
- Allow significant direct investment by foreigners in the government bond market. [PBOC and SAFE]
- Re launch a bond futures market with regulatory, supervisory, and technological infrastructure. [PBOC, MOF, and CSRC]
- Gradually deregulate interest rates.

European Business in China Position Paper 2011/2012:

Banking and Securities

Key Recommendations

I. Market Access

1. Improve the Speed and Transparency of the Approval Process (CBRC, PBOC, SAFE, CSRC)

- Improve regulatory speed, transparency, accountability and reliability with regard to foreign financial services institutions to reduce legal and operational uncertainties.
- Abolish the three-year waiting period to which foreign bank branches are subject before being eligible to submit their application for the RMB licence (CBRC).

2. Develop a Coordinated Approach by Policy and Supervisory Authorities of the PRC Government (CBRC, CSRC, PBOC, SAFE)

- Increase cooperation between the different government and regulatory bodies with responsibility for financial services and establish an authorised government body to coordinate.
- Centralise reporting requests from different regulators and submit these in formal (written) format with deadline periods in line with international standards.

3. Allow Greater Ownership and Business Scope for Foreign Players (SCLAO, PBOC, SAFE, CBRC, CSRC)

- Allow foreign banking, securities and fund management enterprises to compete on an equal footing with domestic institutions, including ownership structures and access to all lines of business.

4. Allow Easier Branch/Sub-Branch and Business Expansion (CBRC)

- Enable locally incorporated banks to provide annual master plans for branch and sub-branch expansion to be pre-agreed in principle.

- Allow multiple, simultaneous branch and sub-branch expansion submissions.

5. Increase Access to the Bond Underwriting Market (PBOC, CSRC, MOF, NAFMII)

- Provide clear application and screening rules for approval and grant foreign banks equal rights with local banks.
- Accelerate the approval of foreign banks and securities companies to underwrite CGB, PBOC bills, and, financial and corporate bonds in the PBOC market.
- Build the basic framework of a normal liquid government bond market:
 - with disciplined issuance programs to support large benchmarks.
 - with liquid classic repo market
 - with active and liquid government bond futures markets.
 - with broad range of liquid OTC.
 - with broad and active investors base – both onshore and offshore.
 - with competitive tax rates.

II. Operational

1. Increase Foreign Debt Quota (SAFE, NDRC, PBOC)

- Increase, and ultimately remove, the short-term debt quota for genuine trade-related uses.
- Deepen onshore liquidity by putting in place market-based means of funding, with PBOC acting as lender of last resort, using international rates as a benchmark

2. Enhance Communication and Emphasis of Regulatory Policies (PBOC, CBRC, SAFE, CSRC)

- Increase two-way communication between regulators and banks about key targets and upcoming policy announcements, to enhance mutual understanding and increase the stability of China's banking environment.
- Encourage the use of market-driven tools to regulate loan growth and enhance the quality of bank decision making and credit evaluation.

3. Review Prudential Ratios (CBRC)

- Remove the net of long-term borrowings from overseas branches from current liabilities, to compare assets and liabilities with the same tenor.

4. Review Loan-growth Restrictions (PBOC, CBRC)

- Improve regulatory coordination on the topic between PBOC and CBRC so as to take the particular situation of foreign banks into account when assigning such quotas - the impact of the foreign banks will be minimal on the macroeconomic picture.
- Incorporate some granularity in relation to the industrial sectors so as to favour the sectors the government wishes to promote, and discourage sectors where, for instance, there may be overcapacity problems.

- Increase transparency so as to supply all players with the same information.

5. Remove the Loan-to-Deposit Ratio Requirements (CBRC)

- Replace the 75% loan-to-deposit ratio with an alternative measure based on international best practices, or at minimum allow the five-year transition period to start from the date of incorporation for each bank, rather than at a fixed date applicable for all.

6. Address Funding Limitations in the CFETS Interbank Market (PBOC)

- Remove the two times capital limitation for all banks in China. •

Introduction to the Working Group

The Banking and Securities Working Group represents more than 40 European banking and securities financial institutions in China (most of whom are active in commercial banking).

Recent Developments

By the end of 2010, market share for foreign banks in China was 1.83% (in terms of total banking assets). It has been indicated by high-ranking representatives of the China Banking Regulatory Commission (CBRC) to the European Chamber in meetings in late 2010 that it would be desirable for the Chinese market to have at least 5% of market share covered by foreign enterprises by the end of 2011. However, this target currently seems unlikely and market share of foreign banks in fact peaked in 2007 at 2.38%.¹ To meet this 5% target, further encouragement of foreign involvement in this sector needs to occur and the European Chamber offers the constructive recommendations in this paper to help this process.

In April 2011, the revised Foreign Investment Catalogue² was released, which maintained that financial services, such as Banking and Securities Companies, would remain “restricted” for foreign involvement in China and that joint-venture requirements for foreign involvement in both Securities and Fund Management companies will be maintained. This is viewed as a missed opportunity to open

up these areas for the further involvement of foreign companies who can bring international experience and expertise. The Catalogue is a revision of a previous edition from 2007 and was released in draft format along with an invitation for comment. The Working Group gratefully accepted the opportunity to submit input on the draft and it is hoped that the encouragement of foreign involvement in financial services in China will be reflected in the final revised version.

A number of significant developments have taken place in relation to the increasing internationalisation of the renminbi yuan (RMB) over 2010/2011 that has positive implications for foreign banks in China:

- Firstly, European banks have been heavily involved in the pilot scheme for RMB trade settlement that has been developing since 2009. There is now a growing offshore RMB market in Hong Kong, and other cities have signaled their ambitions to follow suit.
- In November 2010, China introduced credit risk mitigation instruments - a form of credit derivatives for the RMB bond market. To date, one foreign bank has been approved as a core trader and an issuer of these instruments by the National Association of Financial Market Institutional Investors (NAFMII).
- In January 2011, the People's Bank of China (PBOC) launched a pilot scheme for RMB settlement of outbound direct investments, allowing some Chinese companies to use domestic RMB for overseas direct investment.
- The first RMB initial public offering (IPO) in Hong Kong took place in April 2011 and it is expected that foreign firms will be able to list on the Shanghai Stock Exchange in 2011.

- The State Administration of Foreign Exchange (SAFE) launched RMB options trading on the interbank market from 1st April, 2011, offering companies the chance to hedge against RMB appreciation.
- The PBOC announced on 15th June, 2011 that a trial program has been started to allow foreign companies to use RMB raised offshore to invest back on the mainland. This is the first time China has formalised rules on RMB denominated foreign direct investment (FDI).

The full convertibility of the RMB on the capital account is regarded as a key component in Shanghai, Beijing and other Chinese cities becoming “international” financial centres, and announcements suggest that this will be achieved in the near future with predictions from analysts suggesting that it could become a reality within five years.

In other developments, the China Securities Regulatory Commission (CSRC) announced in June 2011 that foreign banks incorporated domestically would be allowed to sell mutual funds in China from 1st October 2011. This is a welcome development that should introduce competition to the market and benefit the mutual funds, as well as retail customers and investors.

One further notable development is the increasing presence of Chinese banks in overseas markets - including the acquisition of foreign banks.³ This development is significant in that foreign banks are not currently permitted to acquire Chinese banks (as detailed further in the ‘Allow greater ownership and business scope for foreign players’ section in this paper).

¹ China Banking Regulatory Commission, ‘2010 Annual Report’

² Legislative Affairs Office of the State Council, 1st April 2011, ‘The Catalogue of Industries for Guiding Foreign Investment (Draft)’

Previous Key Recommendations

Last year, a major concern of a number of European banks with branch status was the inability to gain approval for China National Advanced Payment System (CNAPS) membership. Since the publication of the previous edition of this paper, significant progress was seen in terms of this issue, with a more transparent approval process put into place. The Working Group would like to acknowledge this progress and is grateful to the PBOC for their action in this area. However, the approval process remains overly long for those still seeking membership.

There are also a number of points that have been removed from this year's paper in order to increase the focus on the priorities of the Working Group over 2011/2012. However, the recommendations below made in the previous paper(s) are still relevant and the issues outstanding.⁴ These include:

- a. Data Processing Location - Foreign banks are required to relocate their data processing systems onshore before receiving the bank card licence. Recommendation: Maintain the existing bank card policy stating data processing systems should be "safe and efficient" without specifying where they should be located.
- b. Local Fund Agency – CBRC, in principle, agrees that locally-incorporated banks are qualified to be the agent of local fund distribution, but to date no specific rules, nor approval by the China Securities Regulatory Commission (CSRC) has been granted. Recommendation: Open local fund agency sales to foreign banks on an equal footing with Chinese banks.
- c. Custody Business - Foreign bank Qualified Foreign Institutional Investors (QFII) custodians need to re-apply for Qualified Domestic Institutional Investor (QDII) custodians' approval, whereas local bank QFII automatically qualify

As of the end of 2010, the five large Chinese commercial banks had set up 89 branches and subsidiaries outside China and acquired or invested in ten foreign banks; six of the national joint stock commercial banks had established five branches and five representative offices overseas and two city commercial banks opened two representative offices overseas (CBRC, '2010 Annual Report').

For further details on any of these recommendations, please refer to the version of this Position Paper (2010/2011) which can be provided by the European Union Chamber of Commerce in China.

for QDII. Recommendation: Grant equal treatment to foreign banks and domestic banks with regards to QDII authorisation.

- d. Taxation issues - No other major country levies indirect taxes on funding and lending activities by domestically-registered banks. Recommendation: Waive the 5% Business Tax on onshore lending. Waive the 10% Withholding Tax on offshore borrowing. Waive the 5% Withholding BT levied on payments to overseas service providers.
- e. Account-Opening Procedures – The additional account opening procedures announced in late-2009 are overly burdensome on operating procedures. Recommendation: Allow a certain flexibility with regards to the detailed procedures based on the CBRC guidelines, as long as the ultimate goal of fraud-prevention can be achieved.

Key Recommendations

1. Market Access

1. Improve the Speed and Transparency of the Approval Process

Concern

Foreign financial services companies often face a complex, largely non-transparent and time-consuming licence approval process.

Assessment

The members of the Working Group understand the regulators' need to perform a thorough analysis of each applicant before granting a business licence. The submission and approval process, however, often appears to be unduly long and complicated. For example, after the local incorporation licence has been obtained by a bank, they must also apply for the corporate and retail RMB licence separately. While it is acknowledged that there is a need for regulators to look at separate approvals, the length of time to do so and the lack of transparency in the process unnecessarily increases the time it takes until the newly-established institution is able to offer services to the Chinese consumer. Such delays make it difficult for the financial institution to plan their investment and resources. This time-consuming process eventually creates legal, operational and market uncertainty for the company seeking approval and it may alter its initial decision to enter or invest further in a market.

The three-year waiting period for the RMB licence is a considerable barrier to market entry and contravenes the basic idea of equal treatment for domestic and foreign banks. In addition to delaying investment in new branches, it also obstructs the development of the Chinese banking sector in an unnecessary way. Given the great efforts of the Chinese government to internationalise the RMB, it is unclear why banks registered within the country are not allowed easy access to do business in the domestic currency.

Recommendation

- Improve regulatory speed, transparency, accountability and reliability with regard to foreign financial services institutions to reduce legal and operational uncertainties.
- Abolish the three-year waiting period to which foreign bank branches are subject before being eligible to submit their application for the RMB licence.

2. Coordinated Approach by Policy and Supervisory Authorities of the PRC Government

Concern

The Working Group continues to see better integration of financial services in China. While businesses quickly adjust to these new requirements, the Working Group observes that coordination among different authorities and government bodies - as well as approval processes - often lag behind to the detriment of improved services for consumers and a sound contemporary financial industry in China.

Assessment

There are a large number of separate regulatory bodies in the area of financial services in China. These include PBOC, CBRC, SAFE, CSRC, the China Insurance Regulatory Commission (CIRC), the State Administration of Taxation (SAT) and the National Development and Reform Commission (NDRC). Also the Ministry of Finance (MOF) is authorised to make decisions on tax incentives for certain financial services that contribute towards social stability.

There is often overlap in the areas of responsibility of these bodies and there are cases where segregated approaches lead to conflicting requirements and, in other cases, separate approaches within the same regulatory agencies but in different geographic regions. This leads

to delays in the timely expansion of the product scope and market structure in financial services and inefficient processes. In general, improved coordination and cooperation would benefit the development of this sector.

After local incorporation, all banks are still required to file or seek approval from local authorities for all new product and service initiatives. This makes the process cumbersome and inconsistent. As banking products become more complex and bundled into solution-oriented products for wholesale and retail customers, there is a need for the relevant Chinese authorities to formulate consistent guidance for all products and services. This will enable more consistent and efficient launches of products that are fast undergoing mass-customisation.

Coordination could be further improved as well in terms of reporting and information requests. The current three calendar-days submission deadline for month-end reporting is too short and causes unnecessary workload peaks in the controller's department. The Working Group suggests that the month-end reporting deadlines should be harmonised with international standards (seven working days). Further to this, regulators tend to submit informal requests for information with very short reply lead times (usually within hours). The Working Group has observed that its members can receive up to 30 of these ad hoc requests and surveys from different departments with often similar content at any one time. The preparation of these reports often involves not only the compliance and accounting departments, but other relevant business departments, particularly offshore parent banks, which makes it very difficult to reach the extremely short deadlines. The Working Group recommends that regulators centralise reporting requests (e.g., business continuity plans, audit-, control-, data reports) from the different regulators to avoid duplication

of work, and that only formal (written) reporting requests are submitted with deadline periods in line with international standards.

The Working Group would like to advocate more effective coordination among financial market regulatory bodies and looks forward to the prompt implementation of any institutional infrastructure that would encourage greater alignment and coordination in the decision-making processes. This issue has been monitored by the Working Group for some years with little progress evident.

Recommendation

- Increase cooperation between the different government and regulatory bodies with responsibility for financial services and establish an authorised government body to coordinate.
- Centralise reporting requests from different regulators and submit these in formal (written) format with deadline periods in line with international standards.

3. Allow Greater Ownership and Business Scope for Foreign Players

Concern

Foreign banking, securities and fund management companies are subject to a number of rigid and long-standing market access restrictions in terms of ownership and business scope.

Assessment

Foreign banks in China are subject to rules that set a 20% ownership limit imposed on any single foreign investor into a Chinese bank (with a cap of total foreign ownership at 25%). These limits have been long-standing since 2001 and restrict the capacity of foreign banks to grow in the Chinese market. In contrast, according to the 2010 CBRC Annual Report, the five largest Chinese commercial banks had acquired or invested in 10 foreign banks by the end of 2010.

Foreign involvement in the securities and fund management business is restricted to involvement in a joint venture with a Chinese partner, with ownership capped at 33% for Securities Joint-Ventures (SJV) and 49% for Fund Management Joint-Ventures. The scope and amount of securities business conducted by the existing SJVs established since China's World Trade Organization entry is negligible.

The business scope of an SJV is limited to underwriting and distributing securities. For brokerage services, SJVs are restricted to B share trading (which would also be subject to SAFE's foreign exchange operation permit). In comparison with the business undertaken by a domestic securities company there are other limitations, for example warrants, convertibles, exchange traded commodities options, securities lending, margin financing are all inaccessible for SJVs.

Recommendation

- Allow foreign banking, securities and fund management enterprises to compete on an equal footing with domestic institutions, including ownership structures and access to all lines of business.

4. Allow Easier Branch/Sub-branch and Business Expansion

Concern

Foreign banks face difficulties in business planning and resource management due to a complex system of submissions to expand their branch and sub-branch network.

Assessment

There are a number of complex submissions that need to be made in order to expand a locally-incorporated bank's branch and sub-branch network. These submissions are time-consuming for both the bank and the regulator and do not provide sufficient information on the future strategic direction of the bank.

Furthermore, the official wording of the regulations does not always lead to clear interpretation, or of the implementation rules and guidelines being 'classified'. Banks often lack a thorough understanding of how many branches they can apply for each year, and how concurrent applications will be treated. This uncertainty goes against China's objective of increasing foreign participation and developing the banking sector in western and north-eastern provinces. European banks have an interest in expanding into western China, however many may be reluctant to apply for branches if this risks causing unplanned delays to their expansion strategies in the eastern provinces.

While the Working Group understands the need for detailed submissions, it would like to recommend a planned strategic approach whereby multiple branch and sub-branch applications will be allowed on an annual basis, in order to facilitate the locally incorporated bank's branch network expansion strategies in a more transparent and planned manner. Consequently, this will allow locally-incorporated banks to strategically expand their branch and sub-branch network in a more timely and efficient manner.

Recommendation

- Enable locally incorporated banks to provide annual master plans for branch and sub-branch expansion to be pre-agreed in principle.
- Allow multiple, simultaneous branch and sub-branch expansion submissions.

5. Increase Access to the Bond Underwriting Market

Concern

Access to the bond underwriting market is difficult to obtain and subject to a number of strict limitations which are not always transparent.

Assessment

Chinese Government Bond (CGB) underwriting is under the scope of MOF, PBOC and CSRC. There are about 60 members of CGB underwriting in total, and of which only three are foreign banks. Since the first foreign bank obtained the CGB underwriting membership in 2004, only two others have been granted this (in early 2008). Specific requirements are given in written form for membership, but regulators also apply stricter criteria - which are not disclosed - to choose members and to keep the total number within 60.

The PBOC bills underwriting market is only open to players with Primary Dealer (PD) certification. It has been stated that the total number of PD would not change as the current number - around 50 - is already large by international standards. There are strict requirements to become a qualified PD and again, in practice the actual requirements are stricter than those given in written form and unclear to applicants. Also the requirements, though not expressly stated, are even stricter for foreign banks than for domestic ones. Currently of the 50 members, only two are foreign banks.

The National Association of Financial Market Institutional Investors (NAFMII) has recently issued new underwriting rules for corporate bonds. The new rules categorise the related members into "Lead Underwriter", "Underwriter" and "Intended Underwriter". As far as we know, no foreign banks have been approved as "Lead Underwriter" for corporate bonds and very few have been appointed "Underwriter". The "Lead Underwriter" qualification has always been held by local commercial banks since 2005. Similarly, only one foreign bank underwrote a financial bond, this was in 2009 and has not been followed by any others.

Working Group members welcome the efforts made so far by financial authorities to establish a strong liquid domestic bond market. The Working Group further understands and supports the government in its step-by-step approach, but at the same time, would like to encourage regulators to proceed more quickly with the reform once it has gained confidence with the initial steps taken.

The willingness to give access to the onshore domestic interbank market for foreign investors is clearly a very progressive step towards improving the liquidity of the domestic interbank bond market. Foreign banks can bring their expertise and technology to this market. Allowing foreign banks to fully participate in the underwriting will offer domestic issuers more choice, leading to more cost-effective options, lower funding costs and expanded distribution channels, as well as encouraging foreign banks to accelerate the required transfer of know-how.

Recommendation

- Provide clear application and screening rules for approval and grant foreign banks equal rights with local banks.
- Accelerate the approval of foreign banks and securities companies to underwrite CGB, PBOC bills, and financial and corporate bonds in the PBOC market.
- Build the basic framework of a normal liquid government bond market:
 - with disciplined issuance programs to support large benchmarks.
 - with liquid classic repo market.
 - with active and liquid government bond futures markets.
 - with broad range of liquid OTC.
 - with broad and active investors base – both onshore and offshore.
 - with competitive tax rates.

II. Operational

1. Increase Foreign Debt Quotas

Concern

In recent years SAFE (and NDRC for the medium/long term quota) has significantly cut short-term foreign debt quota limits and stabilised (or slightly reduced) them for 2011. The trend for quota reduction goes against a trend of increasing FDI that is the core activity of foreign banks. The access to liquidity given by foreign currency inter-bank international markets is of paramount importance for proper and prudent asset/liabilities management. Foreign banks are concerned about funding genuine trade-related financing as the onshore foreign currency market is at a comparative disadvantage to the offshore market due to a lack of liquidity for tenor above the week.

Assessment

The Working Group recognises the government's priority to balance China's short-term and long-term foreign debt, it recognises the value of several regulations in stemming the potential speculation on RMB appreciation, and understands SAFE's objective of moving away from offshore funding and towards onshore funding. The Working Group also commends the regulations that have been promulgated to remove lending for less than 90 days from the quota for trade-related uses. Banks are also willing to move towards onshore funding (the introduction by the tax bureau of the withholding tax and the thin capitalisation rule provide an "incentive" for this). However, unless the onshore market presents a competitive and liquid position at tenor, up to at least one year, banks in China will depend on access to the international market. Clients that have genuine foreign currency funding needs currently see their related costs significantly increasing because foreign banks are unable to support their foreign currency funding requirements from inter-group sources. Not only are

the small quotas a burden, the additional liquidity ratio requirement limits the available funding for clients.

Removing the foreign currency quotas would certainly support the development of Shanghai as an international financial centre and, by helping Chinese exporters and importers to get less expensive trade financing, also support China's foreign trade.

Recommendation

- Increase, and ultimately remove, the short-term debt quota for genuine trade-related uses.
- Deepen onshore liquidity by putting in place market-based means of funding, with PBOC acting as lender of last resort, using international rates as a benchmark.

2. Enhance Communication and Emphasis of Regulatory Policies

Concern

The financial industry is still very much dependent on government intervention regarding the growth and allocation of credit. The use of direct quantitative targets, along with the imposition of policy targets with little advance notice, generates some uncertainty in bank management and does not foster the development of strong, autonomous risk management practices.

Assessment

As part of its focus on restraining inflationary pressures, the government imposed strict limits on loan growth for 2011. In mid-February 2011, the PBOC gave banks their first-quarter loan quotas, which in many cases were lower than the amount of new lending by the banks up to the time of the announcement. As a result, banks had to curtail and in some cases draw back lending to their customers, which in turn put the liquidity of their customers under stress. As of late April, banks had not been notified of their lending

quotas for the second quarter, which in turn leads to some uncertainty about how management should allocate the previously announced full-year quotas.

The Working Group fully supports the government's priority on maintaining macroeconomic stability, but we believe that stability could be further reinforced by providing more advance notice of significant requirements affecting core bank businesses, and by giving banks more opportunity to prepare for their implementation.

Similarly, under measures announced in January 2011 to amend the regulation of the derivatives business by financial institutions, the CBRC announced that the standard-model market risk of non-hedging derivatives would be capped at 3% of bank core capital. The tight level of the cap meant that a number of banks had existing risk exposure that was already above the cap level. This led to some confusion among financial institutions about their future ability to conduct derivatives business in China. The Working Group believes that a period of advance consultation for such regulations would benefit the CBRC as well as the banks, by allowing a productive exchange of information about current market conditions and practices and reducing the need for the CBRC to respond to numerous, urgent bank queries after regulations are announced.

The intent of these policies is indeed to reinforce sound bank management practices, a goal the Working Group fully supports. However, when policies are prescriptive rather than principle-based and are announced without prior consultation, they can lead to unnecessary confusion for banks and their customers.

In previous Position Papers, the Working Group has questioned the oral communication method used and the lack of transparency that this process entailed. More fundamentally, the Working Group believes China should

rely more on market driven lending practices. Indeed, the current practices could lead to moral hazard. Due to the relatively underdeveloped financial market, banks do not have a wide range of investment opportunities. They can lend to corporations or households and buy securities (primarily from the PBOC and MOF). In a competitive environment, banks have a strong incentive to meet their profit targets by increasing lending rapidly. As a result, banks tend to use the time without quotas to lend as much as possible, in order to grow their asset base before new quotas are introduced. This pressure to lend quickly may undermine the ability of banks to conduct careful pre-loan assessments of borrowers and loan proposals, carrying risks for future asset quality.

In addition, the use of prescriptive measures such as loan quotas may be less efficient from a macroeconomic perspective than using market-based tools to restrain lending. Demand for credit has remained very strong in part because real interest rates remain very low or even negative after accounting for inflation. This gives borrowers a natural incentive to borrow as much as possible and also encourages banks to lend more to maximise their interest revenues. This, in turn, forces the regulator to impose quantitative limits on credit growth. However, quantitative limits cut off the flow of credit to high-return projects as well as to those with low returns. The use of market price signals – in particular higher interest rates – to restrain the growth of credit could be more economically efficient by requiring borrowers and banks to reassess marginal investment projects and postpone those that do not generate adequate income. This would benefit the quality of investment in the Chinese economy, supporting its advancement and transformation as well as further strengthening its long-term growth.

Recommendation

- Increase two-way communication between regulators and banks about key targets and upcoming policy announcements, to enhance mutual understanding and increase the stability of China's banking environment.
- Encourage the use of market driven tools to regulate loan growth and enhance the quality of bank decision making and credit evaluation.

3. Review Prudential Ratios

Concern

The net of long-term borrowings financed from overseas branches are treated as current liabilities. This unnecessarily reduces the liquidity ratio as the current assets only cover short term lending.

Assessment

The purpose of liquidity ratios is to ensure a bank's ability to pay short-term obligations. To achieve this in an efficient manner, it is essential that the ratio captures actual solvency. It is international practice to compare assets and liabilities with the same tenor. In the absence of large retail customer deposits, foreign banks rely on overseas intra group funding, including long-term borrowing.

However, in China, the net of long-term borrowings from overseas branches is treated as current liability. This reduces the liquidity ratio, although no immediate demand for repayment is given.

Recommendation

- Remove the net of long-term borrowings from overseas branches from current liabilities, to compare assets and liabilities with the same tenor.

4. Review Loan Growth Restrictions

Concern

In early 2011, foreign banks were verbally advised by PBOC that they would have an RMB lending quota imposed for the year 2011. This has amounted to an effective reduction in the amount of lending foreign banks can do, resulting in a further reduction in market share as well as potentially impacting businesses with critical financing needs in China.

Assessment

The PBOC RMB loan growth restrictions were announced at the start of 2011 and included some intermediary growth targets to be met already by the first quarter of the year. This quota would be equivalent to the increase of loan assets registered in 2010, with monthly and quarterly reviews.

Local Chinese banks do face similar constraints, however as foreign banks are still at an early development stage in China (accounting for under 2% of market share in 2010), they are at a competitive disadvantage. Those banks which have recently invested in China are immediately constrained in their development while they are at the same time asked by CBRC to generate profitability, which in turn will allow them to access more licenses.

As a result of this sudden reduction in lending from foreign banks, corporations with genuine financing needs can face difficulties in supporting their own growth plans in the China market, and worse, face critical financial issues, with a direct impact on the economy.

Recommendation

- Improve regulatory coordination on the topic between PBOC and CBRC so as to take the particular situation of foreign banks into account when assigning such quotas - the impact of the foreign banks will be minimal on the macroeconomic picture.
- Incorporate some granularity in relation to the industrial sectors so as to favour the sectors the government wishes to promote, and discourage sectors where, for instance, there may be overcapacity problems.
- Increase transparency so as to supply all players with the same information.

5. Remove the Loan-to-Deposit Ratio Requirements

Concern

The ratio level of 75% between balance of loans and balance of deposits will come into effect at the end of 2011 for all locally-incorporated banks. While the Working Group acknowledges that this ratio is also applicable to the local Chinese banks, the adverse affect of this ratio on the operations of small and medium-sized, locally-incorporated foreign banks, as well as on newly locally-incorporated foreign banks is particularly serious, as they only have a small branch network and thus a very limited ability to gather deposits from the broader public.

Assessment

Article 39(2) of the Commercial Banking Law sets the loan to deposit ratio at 75% and this will apply to locally-incorporated banks once the grandfathering period expires at the end of 2011.

This ratio is uncommon in international practice as other ratios are considered more effective for controlling banks' operations, for example, 8% capital adequacy ratio and 25% liquidity ratio. The Working Group observes that this ratio incentivises highly cash-collateralised lending that can lead to

misallocation of funds and increased cost for the economy as a whole, and would therefore recommend that it is abolished and replaced with other, more effective means.

If the ratio is to remain, as a minimum measure to mitigate the impact, the Working Group would recommend that the start of the five-year grandfathering period is applied as per date of incorporation instead of having a fixed deadline for all players. The current status quo results in a comparative disadvantage to those banks that entered the market only recently and is a significant obstacle to those planning to enter in the future.

Recommendation

- Replace the 75% loan to deposit ratio with an alternative measure based on international best practices, or at minimum allow the five-year transition period to start from the date of incorporation for each bank rather than at a fixed date applicable for all.

6. Address Funding Limitations in the CFETS interbank market

Concern

Access to the China Foreign Exchange Trade System (CFETS) interbank market is limited to two times the RMB capital of banks in China. Foreign bank branches, by nature, have limited RMB capital in China as their capital is kept at head office level. Therefore foreign bank branches are impacted heavily by this regulation.

Assessment

The two times capital restriction is blocking many foreign banks from more active participation in this market. Lifting the restriction would result in a more active and liquid RMB interbank market which will benefit all banks.

Recommendation

- Remove the two times capital limitation for all banks in China.

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