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Foreign Strategic Investment in China's Banking Sector: Causes and Consequences

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图书在版编目(CIP)数据

外资银行对中国银行业的战略投资:原因和后果/李玉花著.—上海:复旦大学出版社,2014.12
ISBN 978-7-309-11116-3

Ⅰ.外… Ⅱ.李… Ⅲ.外资银行-投资战略-影响-银行业-研究-中国 Ⅳ.F832.3

中国版本图书馆 CIP 数据核字(2014)第 275833 号

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责任编辑/陈彦婕

复旦大学出版社有限公司出版发行
上海市国权路 579 号 邮编:200433
网址:fupnet@fudanpress.com http://www.fudanpress.com
门市零售:86-21-65642857 团体订购:86-21-65118853
外埠邮购:86-21-65109143
当纳利(上海)信息技术有限公司

开本 890×1240 1/32 印张 6 字数 133 千
2014 年 12 月第 1 版第 1 次印刷

ISBN 978-7-309-11116-3/F·2100
定价:24.00 元

Abstract

With the rise of emerging countries in recent years, foreign bank entry into these countries becomes a sensitive issue since many immature financial systems in these countries rely heavily on banks to channel financial resources to development priorities. It is also a hot issue in the foreign bank entry research field. Empirical evidence on the impact of foreign bank entry in emerging countries has both positive and negative results. The evidence of the impact of foreign bank entry in China is important, because foreign strategic investment in China's banking sector is the minority equity investment, which reflects not only the degree of banking privatization, but also the degree of foreign bank entry. Foreign strategic investment in China's banking sector, which has minority ownership and business cooperation as main features, is an important foreign bank entry mode compared with its branches and subsidiaries and it is also an important reform strategy in terms of China's banking liberalization and privatization. Because of these reasons, the author investigates the motivation of foreign banks undertaking strategic investment and its effects on the

performance of Chinese banks.

This study uses both a quantitative and qualitative research approach, secondary data and substantial hand-collected archive data. Previous studies are reviewed in Chapter 2, and the structure and development of China's banking system, the history of foreign bank entry, and foreign strategic investment are detailed in Chapter 3. The main research questions in this study are developed and addressed in Chapters 4 and 5.

Chapter 4 investigates the motivation of foreign banks undertaking strategic investment and the motivation of Chinese banks attracting strategic investment by using substantial anecdotal evidence from home and abroad. Anecdotal evidence suggests that foreign banks are likely to use the strategic investment to get access to local resources, such as distribution networks and local customer base, to expand into the Chinese banking market, and to gain return from the investment. Chinese banks are primarily motivated to improve their efficiency and to get access to foreign banks' financial resources and other intangible resources, such as technology and experience.

Chapter 5 examines the impact of foreign strategic investment on the performance (profit efficiency, cost efficiency, return on asset, and cost to income ratio) of

Chinese banks using fixed effect model and difference-in-difference approach. Chinese banks do not experience performance improvements on average, however, assistance in management system and business cooperation accompanied by foreign strategic investors is improved.

The unique analysis of both quantitative and qualitative researches on foreign bank strategic investment contributes to the study of the motivation that attracts foreign banks to enter into the Chinese banking market and the impact of foreign strategic investment on the performance of Chinese banks, and gives us some policy implications for opening financial markets in emerging countries.

Abbreviation

ABC	Agriculture Bank of China
AE	American Express
ANZ	Australia and New Zealand Banking Group Limited
BBVA	Banco Bilbao Vizcaya Argentaria
BNS	Bank of Nova Scotia
BOB	Bank of Beijing
BOC	Bank of China
BOCQ	Bank of Chongqing
BOA	Bank of America
BCM	Bank of Communications
BOH	Bank of Hangzhou
BoN	Bank of Nanjing
BQD	Bank of Qingdao
TCCB	Bank of Tianjin
CBA	Commonwealth Bank of Australia
CBB	China Bohai Bank
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CIB	Industrial Bank Co. Ltd.
CITIC	China CITIC Bank

CMBC	China Minsheng Banking Co.
CSRC	China Securities Regulatory Commission
EB	Evergrowing Bank
EME	Emerging Market Economy
FDI	Foreign Direct Investment
GDB	Guangdong Development Bank
HSB	Hang Seng Bank
HB	Huaxia Bank
ICBC	Industrial and Commercial Bank of China
IFC	International Financial Corporation
JECB	joint-equity commercial banks
MNB	multinational bank
MNC	multinational corporation
MNE	multinational enterprise
NB	Newbridge Asia AIV III，L.P.
NBCB	Bank of Ningbo
NCCB	Nanchong City Commercial Bank
PBOC	People's Bank of China
PRC	People's Republic of China
QLB	Qilu Bank
RBS	Royal Bank of Scotland
RCB	rural commercial banks
SDB	Shenzhen Development Bank
SOCB	state-owned commercial banks
SPDB	Shanghai Pudong Development Bank
SRCB	Shanghai Rural Commercial Bank
TH	Temasek Holdings Pte. Ltd.

URCB	United Rural Cooperative Bank of Hangzhou
WTO	World Trade Organization
XACB	Bank of Xi'an

Note:

Foreign financial institutions and foreign banks, multinational corporations (MNC) and multinational enterprises (MNE) are used interchangeably.

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Chapter 1

Introduction

1.1 Motivation

(1) Foreign Bank Entry

Starting from the 1990s, foreign financial institutions have been expanding their presence in emerging countries of Central and Eastern Europe, Latin America, and Asia. Herrero and Simon (2003) referred to this phenomenon as the "third wave" of financial institutions' international expansion in which the foreign entry and foreign ownership in the banking sector has increased sharply. In Argentina and Chile, for example, foreign-owned banks have accounted for 50 percent or more of the local banking system assets (Clarke, Cull, Peria & Sanchez, 2003). Foreign bank entry in Central and Eastern European countries has led to foreign ownership in the local banking system often in excess of 80 percent of the local banking system assets (Goldberg, 2007). The proportion of foreign-owned banks remains relatively low in Asia, but it has increased dramatically after the Asian

Financial Crisis (Montgomery, 2003). Foreign ownership is especially sensitive in emerging countries since many immature financial systems in these countries rely heavily on banks to channel financial resources to development priorities (Zhu, 2007).

The main issues about foreign ownership in domestic banks are the benefits and costs caused by the foreign ownership. The positive impact of foreign ownership is built mainly upon the efficiency gains realized by domestic banks due to spillover effects in terms of technology transfer (Goldberg, 2007; Hermes & Lensink, 2004). However, the positive effect can be offset or weakened by the likelihood of domestic banks taking additional risks in dealing with excessive competition (Vives, 2001), possible increases in concentration due to mergers and acquisitions (Agénor, 2003), and even the failure of infant domestic banks as a result of the "crowding out" effect (Song, 2004). Empirical evidence on the impact of foreign ownership in domestic banks also shows inconclusive and inconsistent results (Berger, Hasan & Klapper, 2004; Berger, Hasan & Zhou, 2009; Bhattacharya, Lovell & Sahay, 1997; Bonaccorsi di Patti & Hardy, 2005; Bonin, Hassan & Wachtel, 2005a, b; Yildirim & Philippatos, 2007). Different entry mode of foreign banks into one country and the development characteristics of domestic banks may explain the mixed results of the impact of foreign bank entry on the domestic banking sector.

In general, theoretical and empirical studies on foreign bank entry have not generated conclusive and consistent results. The evidence from China is interesting and important in understanding the impact of foreign bank entry. Therefore, this study attempts to investigate whether the strategic investments improve the performance of Chinese banks and how they affect Chinese banks.

(2) Why Research China's Banking Sector?

Most of the emerging countries in Central and Eastern Europe and Latin America not only deregulated branches and wholly owned bank subsidiaries, but also permitted high levels of foreign equity ownership, especially 100% foreign equity ownership. The first country in Eastern Europe to invite foreign strategic investors was Hungary, and all large Hungarian banks were controlled by foreign banks before the end of 1997.[①] Baltic States, Balkan States, Poland, Czech Republic, Slovak Republic, and Slovenia also permitted foreign strategic investors to acquire equity stakes of their domestic banks and most of their banking capital also was controlled by foreign banks (Havrylchyk & Jurzyk, 2006). However, although China permitted foreign strategic investors to acquire equity stakes in Chinese banks from

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① The only exception was OTP, the largest Hungarian savings bank that was privatized through a public offering on the stock exchange to institutional investors, without a single majority owner.

2003, foreign equity ownership has been limited to 25%. The minority equity ownership in China's banking sector was very different from those in Central and Eastern Europe countries' banking sector.

Table 1.1 lists theforeign equity ownership regulation among Asian countries' (China, India, Indonesia, Thailand, South Korea, Malaysia, and the Philippines) banking sectors. Indonesia, Thailand, and South Korea are the least restricted countries on percentage limits of foreign equity ownership, whereas, China is the most restricted country. In China, foreign equity ownership was not permitted before the 1997 Asian Financial Crisis (it is permitted now), however, foreign investors could hold a 25% equity stakes. Foreign equity investment is highly regulated in China's banking sector, compared with other emerging countries banking sectors, then what attracts foreign banks to China's banking sector?

Table 1.1 Foreign Equity Ownership Regulation Among Asian Countries

Country	Foreign Equity Ownership Permission	
	Pre-crisis (1996/1997)	Post-crisis (2007/2008)
China	Not Available	20 percent — single foreign investor 25 percent — overall investment limit

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