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Expanding Banking and Other Financing Opportunities in China and Australia:
Australia's Banking and Other Financing Interests and Opportunities in China

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Introduction

China's rapid development, coupled with the gradual opening up of its financial markets, presents a future growth option for Australia's financial services providers. But, establishing a foothold in China's financial services markets is challenging and carries risks that may not be well understood in Australia.

The purpose of this paper is threefold. First, to outline why, despite the challenges and associated risks, China is an attractive market for foreign banks. Second, to provide an overview of alternate routes for foreign banks to build a presence in China. Third, to provide an overview of the Commonwealth Bank of Australia's (CBA) activities in mainland China.

China is an attractive market for foreign banks

The regulatory environment impacts the scope of opportunities available to and how foreign banks grow within the Chinese market. Although China's authorities, in part driven by their WTO commitments, have done a lot in recent years to open the banking sector to foreign banks, it remains a relatively closed market. Banking regulations restrict foreign ownership to a maximum of 25% per bank (20% to a single foreign owner) and shareholdings in a maximum of two Chinese banks. Regulatory hurdles also put foreign-funded financial institutions on an unequal footing. Restrictions on inter-bank funding, high capital requirements and restrictive foreign debt quotas, together with restrictive licensing rules, limit business scope. Further opportunities for foreign bank growth are largely dependent on how the regulatory environment evolves to meet market needs. Regulatory restrictions are expected to be relaxed in the medium-to-long term.

Despite the regulatory uncertainty, for a number of reasons, China remains an attractive long term growth market for Australian financial services providers. In particular:

Firstly, economic growth in China is expected to be a key source of global growth over the next 20 years. With the rise of China, and Asia more generally, Australia finds itself not on the periphery of the global economy, but close to its centre.

Secondly, with deepening trade, tourism and services links there's enormous scope for cross-border activity for Australian corporates and small businesses doing business in China. As a key export market, China recently surpassed Japan and the US to become Australia's biggest trading partner. Australia's trade relationship with China is becoming increasingly more diverse. Negotiations for a free trade agreement (FTA) have recently recommenced. There is an increasing volume of direct business investment in both directions. Cultural links, underpinned by migration, education and tourism, continue to grow.

Thirdly, the Chinese government is focused on building a robust financial services sector to underpin long term economic growth. This is being done through the strengthening of the capital base, management skills and governance of domestic financial institutions, and through widespread privatisations. Areas of focus include elimination of directed lending, clearance of non performing loans and transfer of ownership from provincial and local governments.

Fourthly, China provides sustainable high growth potential across the spectrum of financial services segments. The rapid expansion and globalisation of Chinese firms is driving demand for a full range of corporate financial services. Economic growth is driving an increase in the number of small and mid-sized enterprises (SMEs) needing banking services. At the retail level, growth in disposable income and wealth levels is expected to drive significant demand. Additionally, increasing urbanisation is expected to underpin retail banking prospects as the concentration of populations in smaller geographic areas makes distribution easier and less costly, and the expansion of the urban population drives housing requirements and increased mortgage demand. In respect of wealth management and market based business prospects, the modernisation of China's stock and bond markets, coupled with demand for more sophisticated and longer-term investment and insurance instruments, creates a potentially bright future.

Lastly, the emergent nature of China's financial services market creates an opportunity for Australian financial institutions to add value to their Chinese counterparts.

Despite the regulatory challenges and associated risks, taking cognisance of the reasons outlined above, China provides an attractive opportunity for Australian financial services providers looking to drive long term growth.

Routes for foreign banks to build a presence in China

Foreign bank growth options are restricted by the prevailing regulatory environment. As previously mentioned, further regulatory reform is a necessary precursor to opening up incremental growth opportunities. Based on the prevailing regulations, there are limited

direct and indirect entry routes available to foreign banks seeking to build a presence in China.

Direct entry options include; establishing a foreign bank branch, a foreign bank branch converting to a locally incorporated subsidiary after 3 years, or by acquiring an already locally incorporated foreign-owned bank. Option one provides limited business scope (foreign currency license), with no authorisation for RMB business or capacity to serve Chinese citizens. Option two provides the same limited scope as option one during a three-year regulatory waiting period, after which an application can be submitted for local incorporation and conversion to a RMB banking license. Option three provides accelerated market access through the acquisition of an existing RMB banking license. An RMB banking licence enables full service RMB business from the institutional through to the individual level. However, penetrating the local market still remains a challenge for most foreign owned banks.

Indirect entry can be achieved by making an equity investment in an established domestic bank. As previously mentioned, regulations restrict foreign ownership to a maximum of 25% per bank (20% to a single foreign owner) and shareholdings in only two Chinese banks. Four of the five state-owned banks, nine of the twelve joint stock banks and thirteen of the two hundred and six city/rural commercial banks have foreign investors. Few opportunities remain to invest in quality banks of reasonable size at the levels at which foreign banks made their initial investments. The success of an indirect entry strategy is largely dependent on the alignment of investor/investee interests and the forging of a long term strategic partnership. Central to this is an effective capability transfer program.

Commonwealth Bank of Australia in China

China is one of our key strategic markets. As highlighted, China offers opportunities in all financial service segments and continues to expand rapidly. We have a small but established footprint in place to leverage future growth options.

Our business engagement in China dates back to the early 90's with the establishment of representative offices in Beijing and Shanghai to carry out liaison and research functions to identify opportunities for the Group in China. In 2000, through the acquisition of the Colonial Group of companies, we took a 49% stake in China Life CMG, a joint venture with China Life. Its products cover life, accidental, annuity and health insurance. In 2004, we took a 11% stake in Jinan City Commercial Bank, a City Commercial Bank (CCB), with an option to increase our stake to 19.9%. Building on our emerging CCB strategy, in 2005, we took a 19.9% stake in a second CCB, Bank of Hangzhou. During 2005, we also acquired a mortgage broking business which offers mortgage pre-settlement and title registration services to the residential market in Shanghai. In 2006, we became the first Australian financial institution to launch a fund management joint venture in China. Operating under the name First State Cinda, our fully owned fund management arm, Colonial First State Global Asset management, has a 46% shareholding, while China

Asset Management Corporation (Cinda), holds 54%. The initial focus of the joint venture is on managing retail funds invested into domestic Chinese equities and fixed interest.

While our focus remains firmly on enhancing our two CCB investments, as they expand their operations, we are also applying to establish a proprietary branch presence. Initially, this will be by way of establishing a foreign bank branch in Shanghai. Our capability transfer program, praised by China's Banking Regulator (CBRC) as an example of successful foreign investment in China, remains key to our ability to add value to and to strengthen our relationship with Bank of Hangzhou and Jinan City Commercial Bank.

Conclusion

The sheer size of the Chinese market, its proximity to Australia, and the fact that it is likely to sustain a growth rate well above that of Australia for several decades, makes it difficult for Australian financial services providers to overlook China as a future source of growth. The size of the opportunity is largely dependent on the speed and degree to which Chinese authorities relax restrictive barriers to entry for foreign services providers. Australia and China have a lot to gain from a close association, particularly one that gives greater focus to financial services. Given the chance, Australia's financial services providers have the capability to contribute in a mutually beneficial way to the development of China's financial markets.