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Foreign Banks in China 2013

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

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Foreword

Welcome to the 8th edition of PwC's annual survey of Foreign Banks in China.

China's financial landscape has shifted substantially over the past year in tandem with the broader transformation of the economy that is underway. The rebalancing of the economy – from a manufacturing and export driven model to one that is more consumer and service driven – was often discussed a year ago but appears now to be beginning in earnest under the country's new leadership.

As government reform efforts take shape, it may prove to be the dawn of a new era in the financial services sector in China that could present foreign banks with unprecedented opportunities in the long term. A new economic model will require a more resilient and efficient banking sector to meet the evolving needs of companies in China. Despite long-term opportunity, banks must stay ahead of these changes and recognise the challenges they must overcome in the changing environment in the near term.

In uncertain times such as these, decisions must be made with the best information available. We thus seek to provide that information by going directly to the people who know the industry best - CEOs and other decision makers at 37 foreign banks. In addition, PwC Partners have pooled their knowledge and combined decades of experience in the industry to provide their views on where the sector may be headed, as well as key points that foreign bank leaders should consider when setting strategy.

Followers of our past reports will notice a key shift in the methodology of this survey to a format that emphasises more qualitative responses. In response to requests from users of this report, as the pace of change increases, and strategies become more diverse, we have sought to bring a nuanced view of the reasons behind the trends and provide suggestions of where they may go.

Using this approach, we personally interviewed executives at each of the banks and posed eight questions addressing some of the most critical concerns of foreign banks. We sought to protect the identity of individual banks to ensure candid responses and present the views of the sector and certain subsets such as locally and non-locally incorporated banks. Interviews were conducted in September and October 2013.

In assembling this report, PwC would particularly like to extend its thanks to the CEOs and other executives for their time and considered responses to our questions.

We hope you find the results of this survey enlightening and informative.

Matthew Phillips

China & Hong Kong Financial Services Leader

Raymond Yung

China Financial Services Leader

Jimmy Leung

China Banking and Capital Markets Leader

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China Financial Services Partner

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Executive Summary

Overview

Recent statements by Chinese President Xi Jinping, Premier Li Keqiang, People's Bank of China (PBOC) Chairman Zhou Xiaochuan, and other senior political leaders, accompanied by tangible policy and regulatory changes indicate a commitment to change that is more specific and comprehensive than we have seen before. This was reaffirmed at the Third Plenary Session of the Communist Party of China's 18th Central Committee. China's new leadership appears to recognise that the diversity of China's economic growth, which is increasingly reliant on the private business sector and aspirations of increased consumer demand, requires broader policy changes and the development of more sophisticated financial markets. Furthermore, as China's influence on, and interdependence from, the broader global economy increases, powerful economic forces will dictate relaxed currency restrictions and market-based interest rates. In this regard, the Chinese government should be commended for leading these changes, which will enable them to control, rather than be controlled by, their effects.

One banker in our survey noted, in this regard, that "China's macroeconomic situation has dramatically changed in 2013. Future policy and regulatory changes, such as RMB internationalisation and interest rate liberalisation, will have a dramatic impact on the strategies of foreign banks".

As China's economic paradigm evolves, government and infrastructure expenditures (the traditional source of China's economic growth) are intended to be supplemented by increased contributions from the private business and consumer sectors. New policies and regulations, a number of which have been implemented or announced, will be needed to promote growth in these sectors. Foreign banks, however, hope that these anticipated policy shifts will improve the current approval processes, licence requirements and other strictures placed on them and provide more opportunities to innovate and grow.

While foreign bank CEOs are broadly optimistic that forthcoming reforms will create opportunities for them, they continue to maintain a level of scepticism about how these policies and regulations will be applied to foreign banks and whether they will face constraints similar to those that have frustrated them in the past, such as lengthy branch and product approval processes. Many noted, though, that changes such as the China (Shanghai) Pilot Free Trade Zone (SH PFTZ) – which significantly relaxes offshore RMB exchange, remittance and settlement, and trade restrictions for banks establishing branches within the zone – hold significant promise for accelerated and more balanced reform.

Beyond this, internationalisation of the RMB continues, driven both by Chinese government policies and economic forces, both onshore and offshore. The pace of this process, while uncertain, may be occurring more quickly than some banks had anticipated. The RMB recently displaced the Euro as the international settlement currency with the second highest volume, behind the US dollar. Furthermore, the levels of offshore RMB borrowing and lending in international RMB centres are increasing rapidly. Any bank with global operations must develop a RMB strategy and products, which should be able to adapt to the changing pace of internationalisation.

Strategic implications for foreign banks

Fortuitously, the Chinese economy and financial markets were largely insulated from the effects of the global financial crisis. The Chinese operations of most foreign banks, in this regard, remain well positioned to address imminent and fundamental change. Further, many MNCs, as well as Chinese SOEs expanding overseas who are a natural source of customers for foreign banks, have intensified their focus on China. The onus, however, is on the foreign banks to devise strategies to identify and exploit opportunities and broaden their customer base. Having said this, the nature and pace of policy and regulatory change, and economic development generally, may not be consistent. Identifying opportunities, as well as the expansion and creation of new businesses will involve an inherent level of uncertainty regarding the real potential of specific businesses. Those that want to benefit from these changes will have to make decisions about the commitment of resources that will involve strategic risk. Once the view becomes clear, the first movers may be too far ahead for the others to catch-up. Those with an overly cautious strategy will have to recognise the long-term effects of this. There were a number of bankers who commented that they did have a conservative China strategy and were comfortable maintaining it. More insights from foreign bankers, as well as our perspectives, on the nature and effect of relevant policy and regulatory changes on the strategy of foreign banks are discussed in more detail throughout this report.

Diverse opportunities that play to the strengths of foreign banks

Foreign banks have long endured a limited ability to innovate, in practical terms, due to strict regulatory licencing requirements, lengthy approval processes and stringent capital requirements. While difficult to quantify, foreign banks have experienced significant levels of opportunity cost by not being able to fully leverage their inherent advantages in areas including derivatives, cross-border treasury activities, fixed income markets, and investment banking. Many have compensated for this by entering into collaborative relationships with, or making minority investments in, domestic banks and non-bank financial institutions (NBFIs), with varying levels of success.

Anticipated policy, regulatory and economic changes have reinvigorated the thinking of many of the most progressive foreign banks around innovation and diversity, both organically and through partnerships of various types. Many feel that they will have broader opportunities, in terms of both products and services. As China's financial markets evolve, for example, the expertise that foreign banks possess across their global networks in product development, clearing through central counterparties (CCPs) and developing an effective infrastructure for more sophisticated client service and operations, could provide foreign banks with opportunities to improve earnings quality relative to their peers. Another example is lending to SMEs, which is being actively promoted by the Chinese government. Foreign banks that have developed policies and processes to efficiently originate and effectively control lending in this sector may find increased regulatory flexibility. Targeted business expansion like this could compensate for the relatively small capital stock of foreign banks. Of course, ensuring that the Group Head Office fully understands the potential benefits and risks, along with providing the proper support is critical. Many opportunities, in this regard, are addressed both in our Survey Findings and PwC Perspectives sections.

China' s evolving financial markets

The Chinese government recognises that the increasingly diverse needs of China's developing economy and banking industry must be supported by broader, more liquid and sophisticated financial markets to address growing financing and risk management needs. Tangible policy and regulatory changes have accelerated the development of China's financial markets. Notable among these changes are a growing issuance of asset-backed securities (ABS), the establishment of a CCP for the clearing and settling of standardised OTC derivatives trades, continued internationalisation of the RMB and liberalisation of interest rates, and the creation of a consensus Prime Lending Rate. All of these are fundamental changes and analysed more fully throughout this report. Many global foreign banks have an inherent advantage in operating in complex financial markets. The development of diverse financial markets is necessary to provide the scale and products required to sustain China's economic growth.

Of course, as many countries and regions have learned from the global financial crisis, financial markets need to be properly regulated, with well-established market discipline. Many foreign banks operating in other countries and regions have become more efficient in compliance with new regulations. Many of these regulations, while tailored to local circumstances, are fundamentally the same as those being implemented in China, most significantly Basel III. Beyond this advantage, many foreign banks have developed commercial opportunities out of this regulatory morass. Many of these, appropriately tailored, may prove viable in China and provide foreign banks with an advantage in serving the most sophisticated customers. Further, many foreign banks have expended significant effort developing market discipline at the Group level.

Another significant development is the growing presence of large mainland Chinese banks Hong Kong. This is the most logical region outside of mainland China for them to expand across a range of business activities. While foreign banks with established businesses in Hong Kong have a number of advantages over their newly rejuvenated competitors from the mainland, they cannot be complacent. Hong Kong will quickly develop into an even more intensely competitive market.

Additional areas of relevance to foreign bankers

In addition to summarising areas of significance to the bankers whom participated in our survey, we have also addressed other areas that will be discussed in the Survey Findings and PwC Perspectives sections, including views on macroeconomic policy changes and the China (Shanghai) Pilot Free Trade Zone. These areas provide insights into the future direction policy changes may take us.

While we have highlighted the potential opportunities of the evolving changes of China's economy, policies and regulations in this Executive Summary, we recognise the continuing challenges and frustrations noted by foreign bankers. These have been extensively covered in the past and are considered in this report to provide an appropriately balanced perspective. In light of the timing and significance of the developments discussed above, though, we felt that an initial focus on the potential opportunities and benefits would establish a positive tone that we believe is validated. We also recognise the challenges involved in "reaping the rewards" are not insignificant and have also addressed these important matters.

Survey Findings

1. Strategy

Foreign banks in China – Time to be cautious or "double-down"?

Many observers, including foreign bankers, have over the past decade, extolled the long-term benefits of establishing a presence in the Chinese banking industry. Indeed, many have followed the siren song and established Subsidiaries and Branches. The strategies implemented have ranged from creating niche corporate banking businesses to leveraging global wealth management capabilities, as well as many other permutations. To date, however, few of the foreign banks have really distinguished themselves, in terms of bottom line performance, and collectively, their market share has remained virtually unchanged over this period. At the board meeting of a foreign bank in 2013, a director (after listening to a discussion on strategy that included the requisite references to the potential inherent in China's GDP growth and expansion of individual wealth) noted that he had been party to similar discussions over the past several years. In this regard, he asked, quite quizzically, "When is all of this really going to happen and impact our performance"? Others in the community of foreign banks are asking similar questions.

To be sure, it has been a tough slog for foreign banks in China over the past ten years. Lending and deposit restrictions and quotas, geographic constraints, periodic foreign exchange limitations, relatively large capital requirements, lack of regulatory clarity, and slow product and branch approval processes have all, at some point over the past decade, adversely affected the strategies and operations of foreign banks with seasoned management. In an environment of regulatory constraint, it is understandable that a number of foreign banks may have resigned themselves to more of the same. In fact, many of the CEOs participating in our survey did discuss maintaining a stable strategy, as events in China continue to evolve.

Over the past year though, there have been a number of significant events that we believe may be harbingers of real change. Perhaps, most notably, when President Xi Jinping outlined a roadmap for economic reform during a speech at the Third Plenary Session of the 18th Central Committee of the Communist Party of China. By itself, this speech included a number of commendable aspirations related to continued growth of the economy and the development of China's financial markets. It is the actions that have taken place before and after this speech, however, that reflect a tangible commitment to change. These actions include the CSRC's recent announcement of broad changes in the rules related to domestic IPOs and their recommencement; continuing internationalisation of the RMB and interest rate liberalisation; creation of a composite Prime Lending Rate; allocating asset-backed securitisation quotas to foreign banks; centralised clearing of standardised OTC derivatives in early 2014, and a seemingly insatiable demand for RMB trade settlement through designated offshore clearing centres, making the RMB the second most frequently used currency after the US dollar.

An area of particular focus is the recently created China (Shanghai) Pilot Free Trade Zone. It is already attracting MNCs from all industries in droves, even though the detailed rules to implement its benefits and incentives are still being developed and issued. Expectations for this latest experiment with open markets and freer capital flows are high, with foreign banks focused on the possibility of leveraging global markets, where many have a competitive advantage, from the Chinese mainland.

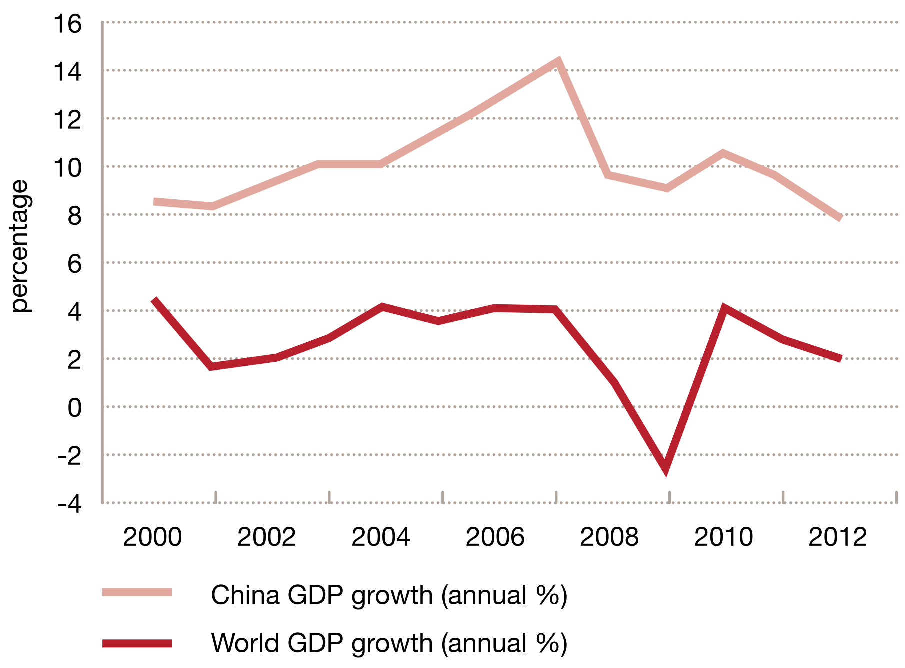
Sceptics could quite easily (and understandably), dismiss these as "more of the same", that often underwhelm in their impact. In fact, this was the attitude expressed by some in our survey. We believe, though, that both the scope and intensity of these actions, which seem to be as much a response to economic forces that are gaining momentum as political calculation, put foreign banks in China on the precipice of real change and opportunity – for those willing to commit to actions that are not without risk.

China's economy has become too large and complex to be supported solely by traditional bank finance, as evidenced by the rapid emergence of its shadow banking sector over the past few years. As was demonstrated all too clearly by the recent global financial crisis, financial markets must be regulated to avoid excesses and irregularities that preclude their orderly functioning. Similarly, financial market participants must perform within regulations - related to market conduct, capital, and liquidity - to reliably ensure their own stability and avoid unintended systemic consequences. We believe that the actions taken by China's financial regulators in recent months reflect efforts to achieve these objectives; while promoting the development of products, services, and market practices to support the increasingly complex needs of China's economy as it continues to grow.

* Subsidiaries refers to locally incorporated foreign banks operating in China
* Branches refers to the foreign bank branches operating in China

We believe that those foreign banks with the commitment to make bold decisions and investments - as well as a board and management with the stomach to endure what will likely be a fair level of uncertainty and volatility - will be well positioned for China's opening economy and financial markets. Those who do not will miss this window of opportunity and, are almost certainly, destined for "more of the same".

Global and China GDP growth



Source: World Bank

Despite the groundswell of developments, through which foreign banks could leverage their relative competitive advantages, many foreign banks expect to "stay the course" on their China strategies, albeit with occasional adjustments in response to the fluctuations of the current global economy. While the potential benefits from these developments are not clear, it seems that they suggest a significance of change in the environment that is worthy of discussion in the context of a strategic review. During 2013, not only were there more references to specific areas of change at the most senior levels of the Chinese government, there were also policy and regulatory actions that served as reinforcement. To be fair, the impact of these actions remains to be seen. Once a level of certainty is achieved, however, those that have moved first may be too far ahead for the others to catch-up.

While size clearly matters, foreign banks have developed competencies in niche areas. These include wealth management using long-term portfolio management, which has proven more effective through economic cycles than a focus solely on products. While foreign banks do not have the scale of their primary domestic competitors, there are business activities that are typically associated with scale, where foreign banks still have the potential to leverage their global networks and compete. These include derivatives trading across a range of products. High volume derivatives trading requires sophisticated risk management and a complex infrastructure to support clearing and settlement, custody, collateral management, and the segregation of customer funds. Further, foreign banks already have experience in other countries and regions working with central counterparties (CCPs) that should enable them to more readily develop an interface with China's new CCP, especially as new products are introduced for central clearing. Notwithstanding current regulatory constraints in this area, more powerful economic forces, and the need for products to effectively manage more complex risks, will compel the approval of new products. Similarly, Chinese banking regulators are opening the market for asset-backed securities (ABS). While the volume related to the current pilot programs can be managed using spreadsheets, perhaps with some difficulty, experience in more developed markets demonstrates that high volume ABS issuers, especially with residential mortgages and credit card ABS, require investments in specialised servicing platforms to realise the efficiencies that make this a profitable business. No domestic bank has such a platform or experience servicing these ABS programs. Many foreign banks do and could readily tailor these for the China market.

Many foreign banks intend to maintain stable China strategies while others explore diversity – Are there missed opportunities?

Bankers that did note they were considering expanding into new businesses included the following areas:

- Providing more services to small-and medium-sized enterprises (SMEs). This in an area targeted for growth by the Chinese government, which has significant potential and perhaps more regulatory flexibility for banks that have this capability.
- Winning mandates from state-owned enterprise (SOE) clients undergoing restructuring or expanding abroad, particularly for those banks that have developed specialised lending units for key industries (e.g., shipping, energy, and aviation).
- Offering rural banking in support of Chinese government efforts to promote growth across the domestic economy in previously underserved areas. Cities recently attracting the attention of foreign banks include Chongqing, Chengdu, and Harbin.
- Pushing inland to follow manufacturing growth and the government's campaign to "develop the West" and foster urbanization.
- Launching e-banking or other online services, possibly forging alliances with non-bank online lenders.

Notably missing from these initiatives is China's rapidly expanding service sector which is receiving policy support. This includes areas such as healthcare, education, and professional services. Many foreign banks have experience servicing these industries abroad and better understand their needs. Similarly, many MNCs believe that the SH PFTZ will provide significant opportunities to make their cross-border RMB treasury and cash management more efficient. This is a core competency and relatively low-capital business.

While most of the foreign bankers remain optimistic about the long-term growth prospects in China, whose economy and financial markets have been relatively well insulated from the effects of the recent global financial crisis; few noted a major change in strategy. Many indicated that they were waiting to see how regulatory changes play out, and would react as circumstances changed, although a number indicated that they would aggressively explore opportunities in the SH PFTZ. While it is understandable that certain foreign banks have experienced frustrations in their attempts to expand in the past, those that are taking on more strategic risk may find themselves in a stronger long-term position than their peers. Quarterly earnings will continue to be a KPI, and may itself be a constraint to risk taking, but surely accommodations can be made to develop modified KPIs for businesses that will develop over the medium term. Further, the simple fact is that foreign banks are continuing to grow. Thinking more broadly and taking a little more risk could accelerate this. One example of this is that some foreign banks define their "China business" and assess its performance by considering the mainland China financial results; offshore banking (e.g., Hong Kong and London), most often trade settlement, remittances and loans, that originate in China; and China outbound business. This provides a larger, and some contend, a more complete basis on which to assess investments in new businesses.

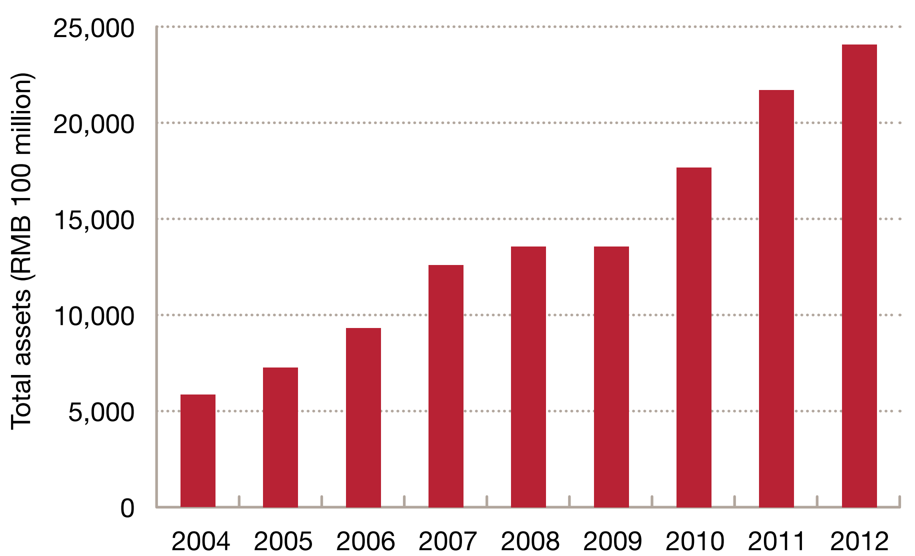
Foreign banks should take the opportunity to reassess new businesses that leverage their global capabilities, with a longer term view of assessing the performance of these businesses.

Foreign bank operations in China (2004 – 2012)

Item / Year	2004	2005	2006	2007	2008	2009	2010	2011	2012
Number of institutions	188	207	224	274	311	338	360	387	412
Total assets (in RMB 100 million)	5,823	7,155	9,279	12,525	13,448	13,492	17,423	21,535	23,804
As % of total banking asset in China	1.84	1.91	2.11	2.38	2.16	1.71	1.85	1.93	1.82

Source: CBRC Annual Report 2012

Total banking assets of foreign banks (2004 – 2012)



Source: CBRC Annual Report 2012

Growth beyond banking

Beyond considering the expansion of their banking businesses, several have implemented strategies for entering businesses that are currently the domain of non-bank financial institutions (NBFIs), and increasing their exposure in this area. The obvious attraction of these businesses is that they are subject to less regulation, (for the time being), enabling them to think more broadly about innovation and product diversity. These are areas in which most of the bankers participating in our survey feel constrained. NBFI businesses include specialist consumer lending, trusts, asset management, securities brokerage, guarantee companies and insurance.

Most foreign banks that have exposure to these businesses have done so through investment, primarily in businesses that complement their core business and competency, and the sharing of expertise and processes. They believe that this enables them to most effectively oversee and actively participate in the relationship. Further, a number of products have been tailored to meet the needs of specific foreign bank customers.

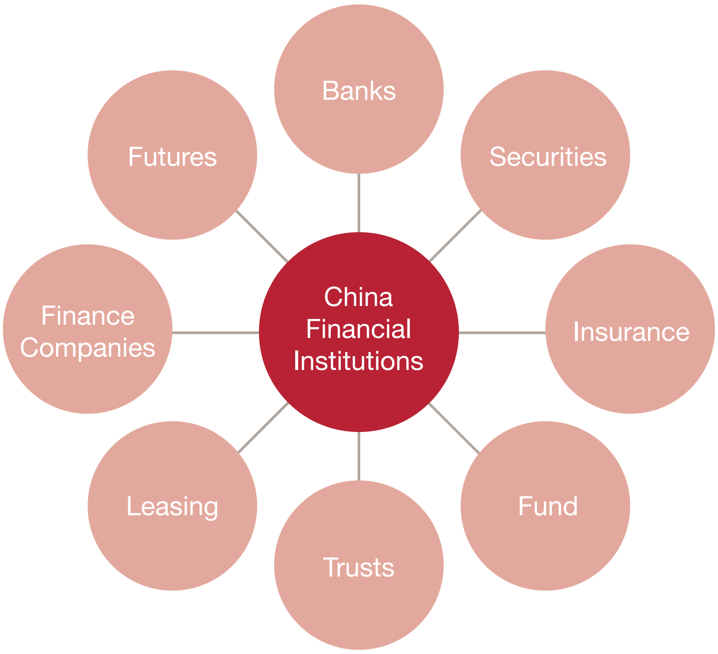
While most of these relationships are in their formative stages, they could prove invaluable, if China's financial regulation expands to include the concept of a financial holding company. This could create opportunities, among other things, for acquisitions and joint ventures. Not surprisingly, a number of banks are actively seeking new and broader relationships with NBFIs.

Relatively lower levels of regulation, of course, cuts both ways. These relationships provide foreign banks with an opportunity to create exposure to and be involved with businesses in which they have expertise. There is, however, a higher risk of issues arising that could affect foreign banks, in terms of both financial exposure and reputation. China's financial regulators are, in fact, beginning to focus on NBFIs, to address issues of opacity, especially related to the disclosure of product risk and product suitability. In any event, effective oversight of these relationships is critical. For example, incentives and a governance process to ensure mutually intended objectives are achieved can be implemented.

A number of smaller foreign banks, primarily Branches, are exiting relationships with asset management companies. Strategy issues, such as an inability to effectively leverage the relationships, were cited most often as the reason. These Branches have less capital and ability to redeploy resources. Some of these banks are considering investments and collaborative arrangements with smaller domestic banks, which they consider a better complement to their more modest strategies. As in other areas, larger Subsidiaries have an inherent advantage over their smaller Branch counterparts regarding strategic investments and collaborative investments.

Foreign banks should continue to explore opportunities with NBFIs, focusing on both the near-term and longer term prospects. They should also consider the possibility that these NBFIs could be subject to increasing levels of regulation, which they could constrain the ability of NBFIs with respect to innovation and product diversity. Foreign banks should also consider whether they will be able to exercise the intended level of oversight.

Different types of financial institutions in China as of 2012 (by legal entities establishment)



Sector	# of Establishments
Banks	**2,617**
Non-Bank Financial Institutions	**262**
Trusts	67
Finance Companies	150
Financial Leasing Companies	20*
Others: Auto Financing, Consumer Finance, and Money Brokerage	25
Securities Companies	**114**
Insurance Companies	**153**
Fund Management Companies	**77**
Futures Companies	**168**

* Note: There are 20 financial leasing companies under CBRC's supervision. Overall, there are about 560 leasing companies nation-wide.

Source: CBRC, CSRC, CIRC, China Futures Association

Market discipline

As China's banking industry and financial markets continue to develop, policies and regulations will continue to be issued in order to develop a level of market discipline sufficient to effectively manage increasing levels of volume and complexity. The MOF, PBOC and CBRC, in fact, have been issuing such regulations in areas that, while certainly not all-inclusive, include, Basel III (capital and liquidity), wealth management products, enhanced risk disclosures, establishment of a composite Prime Lending Rate, and increased regulatory reporting. These regulations are consistent with recommendations by the G20, FSB, BCBS, IOSCO and others. As products become more diverse, creating more complex risks that must be managed, additional regulations increasing market discipline will be issued. These regulations require additional information and processes, as well as changes to business practices to ensure compliance. Again, foreign banks have experience implementing regulations related to market discipline. However, the exisitng regulations have, and future regulations will continue to have, attributes unique to China which foreign institutions will need to adapt to. Addressing these will continue to require significant incremental effort, but fundamental compliance capabilities should be leverageable across foreign banking groups. Further, the culture of compliance embedded in the governance process of foreign bank groups should enable their foreign operations to obtain the required resources and engage effectively with group compliance units, and their boards of directors, to minimise disruptions to their daily operations. This should prove to be a relative strength, as regulations related to market discipline become more complex.

Beyond compliance, demonstrating an unwavering commitment to market discipline has been associated with a perception of strength and quality in more developed markets. In extreme cases, those being viewed as lacking market discipline have lost business (although this opportunity cost is difficult to measure) and faced regulatory sanctions and fines. The strength of Chinese banks has long been associated with balance sheet size, NPL ratios, and profits. These are certainly relevant measures but as off-balance sheet activities increase and the sources of profits become more diversified, the market's perception of a bank's commitment to market discipline will become more relevant domestically as an indicator of a bank's strength.

The bankers participating in our survey all mentioned a strong commitment to compliance, but this is an area where foreign banks could be proactive. In fact, a number of them have already done so at the Group level. For example, regulators, analysts and other constituents will be expecting expanded risk disclosures, such as those recommended by the FSB Expanded Disclosure Task Force. A number of the largest foreign banks in China are implementing these at the Group level and the information should be available to produce similar disclosure related to China operations, either in statutory financial statements or a separate document that covers their "China business" (i.e., including offshore activities).

Foreign banks should be proactive in demonstrating their commitment to market discipline. While this may create limited traction in the short term, there is invariably a flight to strength and quality in times of stress or crisis. The perception of a strong commitment to market discipline, a strength of many foreign banks, may compensate for their relatively small size with an increasing pool of more sophisticated customers.

Regulation – Concern and potential opportunity

Effectively managing regulation, while easier said than done, is a fundamental imperative for the expansion of foreign bank businesses. As regulations become more complex, it may be more difficult for regulators to distinguish between domestic and foreign banks, as practical and administrative matters. While regulators will always be cognisant of their responsibility to support the domestic banking industry and financial markets, the experience of foreign banks may be needed to continue effective development. Foreign banks already meet frequently with regulators to discuss their perspectives on new regulations, which will become increasingly complex. Those that are able to "crack the code" will find themselves in a unique position.

With the plethora of regulations issued in 2013 – which all banks in China should expect to continue as China's banking industry and capital markets grow, diversify, and become more complex – foreign banks have expressed new concerns. Regulators have placed more stringent requirements on foreign exchange net-open positions, resulting in decreased trading activity and profits. Ongoing efforts to liberalise interest rates have put pressure on net interest margins. A credit crunch in June and again at the end of the year, has led to continuing speculation as to whether regulators will move to more actively curb credit growth.

These concerns compound existing frustrations with slow approvals for new branches and new financial products. Some foreign banks also expressed frustration with an inability to obtain controlling stakes in local banks. Some bankers participating in our survey noted that minority shareholders can often be ignored in corporate decision making in China. Nevertheless, as noted above, a number of foreign banks feel that their involvement in investments in NBFIs and smaller banks are manageable.

While more regulation requires increased Board oversight, management attention and resources to ensure compliance, this is a global phenomenon. Globally, as the fog of implementation begins to clear, the most aggressive banks – beyond the lobbying for leniency and dire predictions of the impact of regulation – are exploring the reengineering of their business activities and processes to increase profitability. Again, the thinking and experience of many foreign banks in this area globally could be useful in doing the same in China. Here, the relative size of foreign banks can be an advantage, as large domestic banks have a much more complicated task of implementing regulations consistently across a much larger organisation.

Having said this, foreign banks in China have found themselves on a relatively "short leash" by regulators, consistently citing approvals for new branches and financial products, a generally slow and cumbersome process. Despite steady growth, as a group, foreign banks have long been held to roughly a 2% share of the market, as regulators seem protective of domestic banks.

Several bankers expressed that regulators seem to be "of two minds" about foreign banks in China. When it suits their needs, for example when domestic banks are seeking foreign banks as strategic investors, regulatory matters are resolved quickly. At other times, such as when foreign banks want to increase their capital levels or convert non-RMB capital injections into RMB, the banks indicate the regulators can be less proactive.

2. RMB internationalisation

An international RMB befits an international bank

The continuing internationalisation of the RMB represents a tremendous opportunity for foreign banks in China to expand their cross-border business and more effectively leverage their global networks. It also complements the Chinese government's push for SOEs, who are engaging in cross-border financial activity far more actively, and large private enterprises to "go global", increasing the likelihood that this important area of reform will continue unabated.

In responding to our survey, most foreign bankers expressed their belief that the internationalisation of the RMB is a priority for the Chinese government, but they expressed uncertainty as to the pace of change or the nature of regulations that will be enacted to increase internationalisation.

With increasing frequency, though, new products are launched, transactions announced, and overseas activities are approved that are seen as precursors of RMB internationalisation. These include trading in RMB cross-currency swaps, commencement of RMB bond sales in Taiwan, and the opening of offshore RMB trading centres. While still in the early stages of its development, the operations of SH PFTZ, as a potential incubator of future policies related to broader internationalisation of the RMB, may provide some insights. Activities there could also have the effect of accelerating the process.

Even those foreign banks that do not currently have a high volume of RMB settlement activity are preparing to accommodate what many foreign bankers believe will be a significant increase in demand.

Increased cross-border RMB activity is inherently a bit insulated from the domestic regulatory process, permitting foreign banks to more readily leverage their global capabilities and advantage. As a result, many foreign bankers indicated that it is important to be "in front of the pack" as opportunities in this area evolve.

Continued RMB internationalisation is a precondition for the continued pace of Chinese economic development and China's growing influence in the global economy. This will, naturally, provide foreign banks with opportunities to more efficiently use their balance sheets globally for business originated on China and offer a broader range of products tailored to the needs of global customers.

Realistic optimism

The overseas business of many foreign banks in China is growing faster than their domestic business, their CEOs say. Even among those that did not comment specifically on the growth of their cross-border business, there was a palpable sense of optimism regarding RMB internationalisation.

While the RMB continued to appreciate this year, most foreign banks believe that it will not, by itself, have a significant impact on their business as it has had in the past. Seasoned bankers understand that sustainable profits are a product of innovation and market acumen, rather than reliance on the continued appreciation of the RMB. In fact, we have actually seen RMB hedging transactions that contemplate depreciation of the RMB. Not surprisingly, Subsidiaries appear to have significantly higher levels RMB cross-border business than their Branch peers. Again, their size advantage allows them to provide more diverse services to major Chinese SOEs and support a broader range of products and services.

RMB now 2nd most used currency in trade finance, overtaking the Euro

SWIFT RMB Tracker shows that the RMB has a share of 8.66% in trade finance in October 2013

Published on 03 Dec 2013 (http://www.swift.com/about_swift/shownews?param_dcr=news.data/en/swift_com/2013/PR_RMB_nov.xml#)

Brussels, 3 December 2013 – Recent SWIFT data shows that RMB usage in traditional trade finance – Letters of Credit and Collections – grew from an activity share of 1.89% in January 2012 to 8.66% in October 2013, propelling the RMB to the second most used currency in this market. It ranks behind the USD, which remains the leading currency with a share of 81.08%. The RMB overtook the Euro, which dropped from 7.87% in January 2012 to 6.64% in October 2013 and is now in third place. The top 5 countries using RMB for trade finance in October 2013 were China, Hong Kong, Singapore, Germany and Australia.

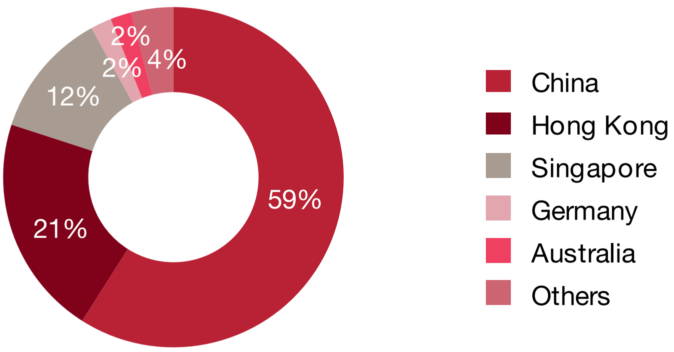
"The RMB is clearly a top currency for trade finance globally and even more so in Asia, as shown by SWIFT's business intelligence statistics on the pace at which China's exporters and importers and their counterparts use the RMB for Letters of Credit", says Franck de Praetere, Head of Payments and Trade Markets, Asia Pacific, SWIFT.

In October 2013, the RMB remained stable in its position as the #12 payments currency of the world, with a slightly decreased activity share of 0.84% compared to 0.86% in September 2013. Overall, RMB payments increased in value by 1.5% in October 2013, whilst the growth for all payments currencies was at 4.6%.

Trade Finance

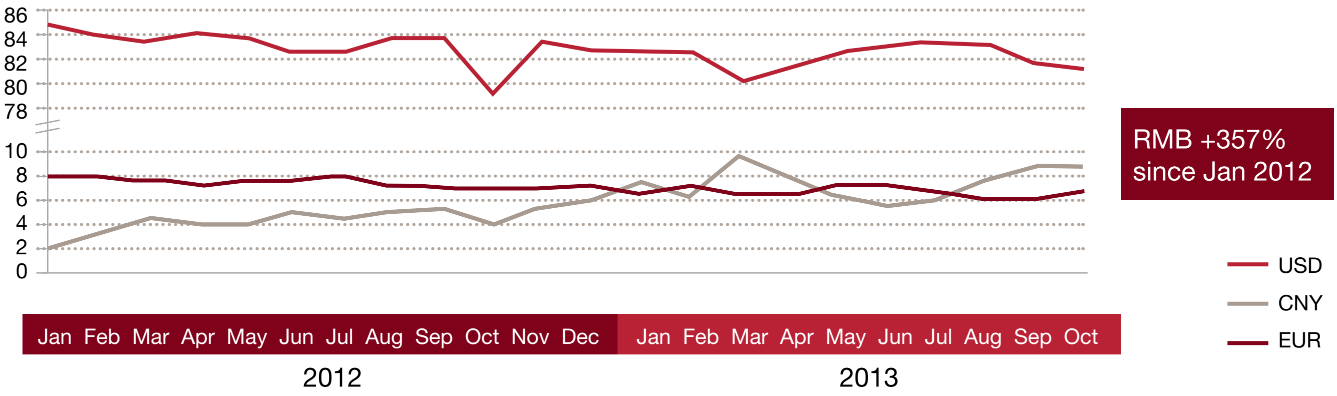
CNY is the 2nd most used trade finance currency

Top 5 countries using RMB for trade finance in October 2013
Value sent and received with the rest of the world



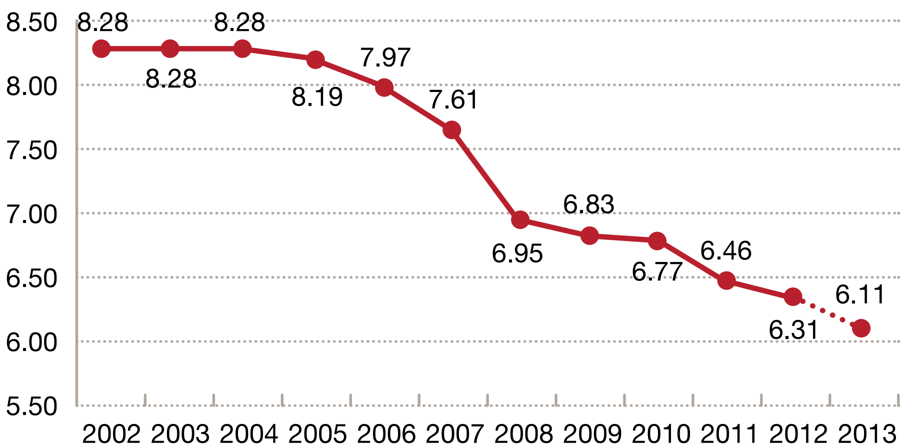
Source: SWIFT

Activity share of 3 main trade finance currencies
Sent and received with the rest of the world



Source: SWIFT

Average middle exchange rate for USD to RMB



Source: World Bank

3. Hong Kong – A changing competitive landscape

Hong Kong – Mainland Chinese bank expansion

Mainland Chinese banks have recently succeeded in pushing aggressively into Hong Kong with cross-border services. Both foreign and mainland Chinese banks long recognised that a presence in Hong Kong serves as a vital gateway to global markets. In the past, however, the activities of mainland Chinese banks in Hong Kong, with the notable exception of Bank of China Hong Kong, were relatively limited.

The competitive dynamic seems to have undergone a fundamental, and we believe, irreversible change as mainland Chinese banks expand both the scale and depth of the cross-border business. It is certainly the region outside of mainland China where they have the most significant level of influence and can hone their global market expertise before expanding aggressively in other countries and regions overseas.

Having said this, though, foreign banks are able to leverage their global networks and products in Hong Kong, which enable them to more effectively and efficiently address sophisticated needs of customers than in mainland China.

Similarly, Hong Kong is the first place that SOEs consider when expanding into global markets. This, combined with the growing presence of mainland Chinese banks, should ensure Hong Kong's position as a true international financial centre into the foreseeable future.

Foreign advantage in Hong Kong – For now

While the competitive dynamic has changed, foreign banks can maintain their inherent competitive advantage, but they must not become complacent. Several bankers observed that mainland Chinese banks have made progress in Hong Kong by emulating their approach in mainland China, relying on their ability to effectively work with regulators and leveraging relationships with large SOEs.

While this may be true today, economic and market realities will force them to adapt to the needs of global customers, or they will become much less relevant. In this regard, it is worth noting that mainland China has completed fundamental reforms over the past decade and created a fair level of momentum around change, which should not be underestimated.

For the foreseeable future, Hong Kong will continue to be a critical battleground, in which mainland Chinese banks will tout their advantage in mainland China with their unique position in serving SOEs and foreign banks continue to maintain the competitive edge with their global network and international experience. At the same time, they will both be attempting to strengthen their existing advantages and develop their areas of relative weakness. The stakes as they say, though, are high.

Foreign banks broadly indicated that Hong Kong provides a much more level playing field and competition is already intense. Further, a number of the International Banking Groups that have Branches in China have a much larger presence in Hong Kong, enabling them to compete more aggressively. Further, success in Hong Kong is, ultimately, less about volume but consistently offering an innovative and broad range of products.

Foreign banks with a presence in Hong Kong must reassess their strategies to consider the growing presence of mainland Chinese banks. Given the resources of these banks, circumstances could change quickly and fundamentally. Complacency could permanently affect their Hong Kong franchises.

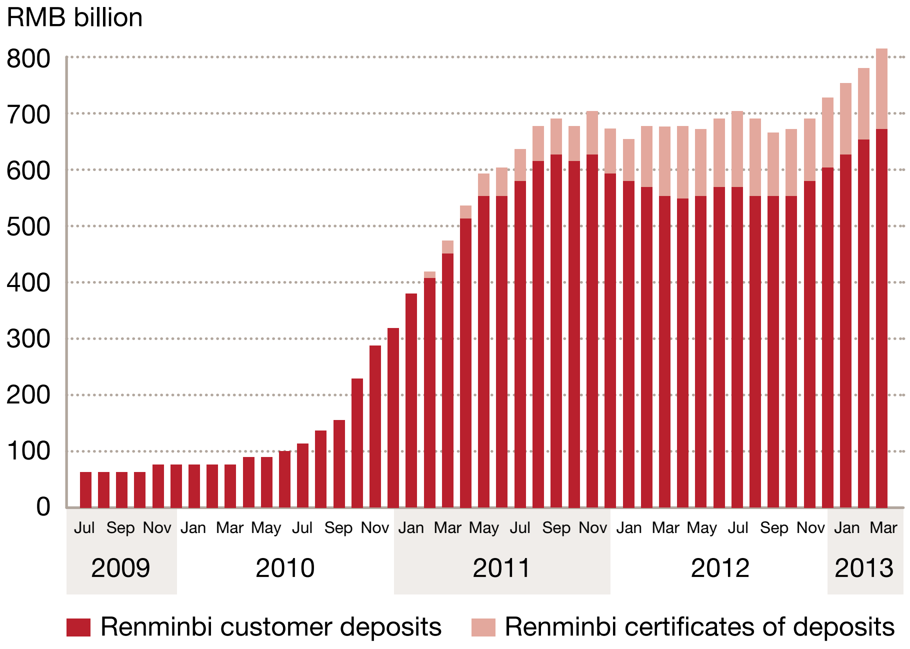
Looking into the future beyond Hong Kong

Some foreign banks have expressed concerns about Chinese banks going after their clients in their own home regions, such as Europe and the US. Foreign banks may look to partner with them, promising the best levels of service both in China and abroad. But in reality many of these relationships can be tenuous and the relatively higher level of bureaucracy at Chinese banks can prove to be a burden. One bank said it prefers to partner on a transaction-by-transaction basis rather than fostering long-term relationships.

One of the few lessons that foreign banks can draw from Chinese banks is on regulation and market openness. Chinese banks, aided by the unity of being mostly state-owned, have proven to be a force for lobbying other countries to open up their financial sectors. Foreign banks, by contrast, remain very limited in China.

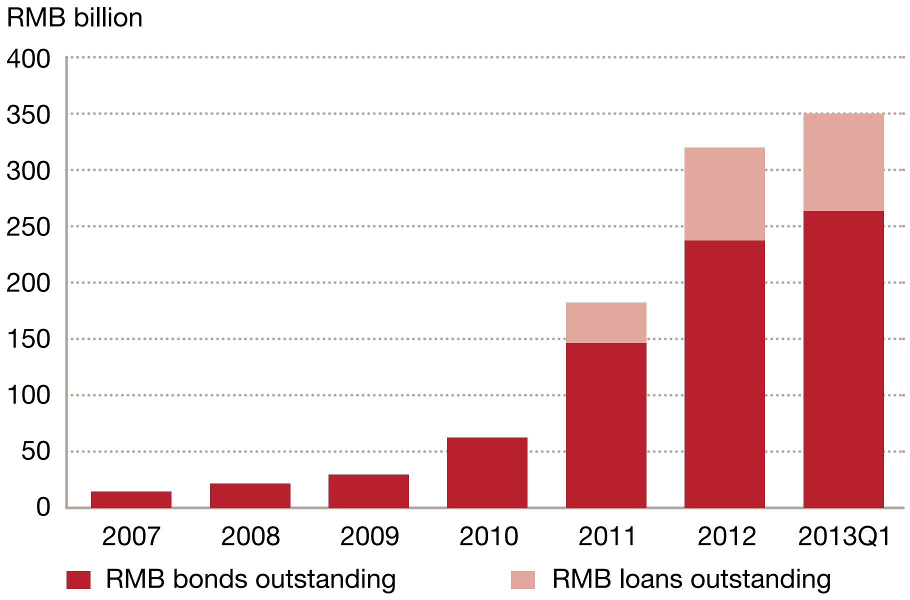
Foreign banks must be prepared for a possible sea change as Chinese banks become more experienced abroad. The level of expertise of mainland Chinese banks will rise in direct relation to the time and resources invested in international operations. This could impact the advantage of foreign banks abroad over the longer term.

Renminbi deposits in Hong Kong



Source: Hong Kong Monetary Authority

Renminbi financing in Hong Kong



Source: Hong Kong Monetary Authority

4. China (Shanghai) Pilot Free Trade Zone

All eyes on the China (Shanghai) Pilot Free Trade Zone

Among the many pilot liberalisation projects, the China (Shanghai) Pilot Free Trade Zone (SH PFTZ) has most captivated the attention of the foreign banking community and had also raised the most questions. The SH PFTZ, launched on 29 September, 2013 and could be a real "game changer" for financial markets in China, and its whole economy.

By comparison, there is comparatively little discussion among banks about the Qianhai economic zone, located just across the border from Hong Kong. The reason is simple. Qianhai began as an empty plot of land, while Shanghai's Pudong district where the SH PFTZ is located already has developed hard infrastructure. Many foreign banks also perceive the policies of the Qianhai zone as being too narrow to derive significant benefits.

The optimism of foreign banks regarding the SH PFTZ is based in its well-defined and broad policy objectives, as well as the specific potential benefits that they can envision from the evolving regulations.

Foreign banks "Wish list"

The "wish list" of foreign banks related to the SH PFTZ runs long. Interest rate liberalisation, essentially abolishing the cap on deposit rates, could greatly benefit foreign banks. To date, domestic banks have largely relied on the floor on lending rates and cap on deposit rates to ensure a healthy profit margin. But they also have little experience in pricing risk into interest rates, an area where foreign banks have abundant experience.

Full RMB convertibility, is also at the top of the "wish list", as it could help them attract much needed deposits and broaden their range of product offerings. The devil, as they say, in the detail. A number of bankers, in this regard, wondered whether RMB convertibility would develop equally for banks, NBFIs, companies and individuals. The answer, of course, will affect plans in this area.

Foreign banks are also hoping for lower reserve ratio requirements in the SH PFTZ, along with elimination of the foreign currency debt and foreign currency investment quotas. The regulations on fundamental issues like these, as well as practical issues like the relocation of staff to the SH PFTZ, remain unclear.

If all the of the regulatory changes on the "wish lists" of foreign banks are implemented, it would be tantamount to a full opening of the capital account, which would in theory place all banks, foreign and domestic, on a level playing field at least within the SH PFTZ. Some foreign banks even believe the zone could be the next incarnation of Shenzhen, testing policies that are later expanded to the entire country.

Foreign banks have high expectations and eagerly await the issuance of implementing regulations to better assess the potential benefits.

Foreign banks – Optimists and sceptics

The views of foreign banks on the potential of the SH PFTZ vary from the staunch optimists to the extreme sceptics. Many, though, fall somewhere in between. Several of the most optimistic foreign banks, both Subsidiaries and Branches, have opened or applied to open branches in the SH PFTZ.

The larger Subsidiaries, though, seem to be slightly more willing to forge ahead into what is currently a relatively uncertain regulatory environment. This may simply be attributed to the more limited resources of foreign banks with a smaller presence in China, and relatively limited resources. Most Subsidiaries, in addition to having more resources, have more experience with the process of establishing domestic branch locations; notwithstanding the special circumstances of the SH PFTZ. Some foreign banks may also have applied to establish a branch in the SH PFTZ to curry favour with regulators.

Many other foreign banks are following a "wait-and-see" approach. Once there is more clarity on regulations, they will work to convince their Group Head Office to create a new branch in the SH PFTZ. Some bankers suggested that a number of their MNC clients and Group Head Offices remain sceptical of the prospects of the SH PFTZ. Others expressed a strategy of "if the client goes, we go" and are therefore waiting for their clients to act.

While all foreign banks undoubtedly harbour similar desires for the success of the SH PFTZ, many remain sceptical. They cited that, at the time of the survey, it wasn't even clear if finance would fall within the scope of the SH PFTZ policy objectives. Others argue that the intention of regulators is merely targeted at domestic banks and not foreign banks.

Even if many of the policies and regulations on the "wish list" are enacted, they would make little impact on the domestic banking environment if banks are not permitted to lend from the SH PFTZ into mainland China. Others are concerned that regulators could change or reverse course on SH PFTZ policies, making an initially attractive prospect into a no longer profitable experiment.

For those with the resources and the willingness to act on some of the most clearly policy objectives in the past decade, the SH PFTZ seems like a reasonable play.

The next Hong Kong or Singapore?

If the benefits of the SH PFTZ largely materialise, it could potentially serve as the catalyst needed for Shanghai to rival Hong Kong and Singapore, as an International Financial Centre. Shanghai currently lacks the deep pool of financial talent of the two more established International Financial Centres. But Shanghai has gradually been gaining ground and the development of talent and other requisite infrastructure could accelerate if financial markets are fully liberalised.

The SH PFTZ could also make Shanghai a threat to Singapore, as some banks see it as a natural location from which to provide services to the shipping industry. Other banks involved heavily in commodities envision Shanghai challenging London or Chicago as a centre for trading commodities contracts.

For now, such scenarios are distant possibilities. But foreign banks are keenly awaiting the latest implementation details on the SH PFTZ.

The Chinese government has made a number of significant policy commitments in establishing the SH PFTZ and the financial world will be closely watching developments, which could ultimately determine the fate of Shanghai as an IFC.

Intention of the 37 banks surveyed about the China (Shanghai) Pilot Free Trade Zone

	No. of banks
Wait and see	24
No plan yet	6
Plan to set up branch or sub-branch	6
Plan to set up a WFOE	1
Total	37

5. Talent

Foreign banks face an unending search for talent

Nearly all foreign banks struggle to find and retain sufficient talent to support the continued growth of their mainland operations. The foreign banks seem to be losing their competitive advantage in the talent market, mostly due to the relatively poor performance and lack of stability during the financial crisis, and the rapid improvement of career prospects in state-owned and national commercial banks which helped to attract both new graduates and experienced talent. It is also challenging for foreign banks to maintain a balance on growing local talent without losing speed on business expansion.

The situation has improved among foreign banks that shared turnover rates, which said they said had generally stabilised in the low double-digits. This figure in itself represents progress as banks are mostly able to staunch the flow of talent to other financial institutions, through a better focus on talent development programmes and staying focused on established footprints rather than aggressively expanding into new provincial branches.

Most foreign banks in China said their staff were overwhelmingly Chinese. But given the limited number of years of reform, the existing domestic talent supply is still limited, especially people who are equipped to take on upper-level management roles.

Pay and incentives

Pay packages remain key to finding and retaining talent. Domestic banks regularly poach employees with attractive compensation packages, and staff can become accustomed to frequently changing jobs in search of ever higher pay. Some of the larger foreign banks said they have low turnover because of their relatively high pay. Others said they do not see that it is sustainable to offer high pay for talent management. Instead they see the global network, international mindset and advanced products and skills – a foundation of a broader career – as being the core employment value proposition to competing for talent in the China market.

Moulding the talent

A number of foreign banks have established graduate training programmes to attract ample academic talent and mould these individuals into functional banking personnel. Training programmes can instil, in part, a foreign bank's corporate and home country culture, but likely cannot bridge the full cultural divide. Effectively blending this with Chinese business practices is the key to success. Many foreign banks send Chinese employees to the bank's home country to facilitate cross-cultural understanding.

Hong Kong and Singapore provide a ready pool of internationalised, Chinese-speaking financial personnel that banks could potentially tap into. However, foreign banks may find it challenging to entice these workers to come to or stay in the mainland.

But others contend that cultural differences can be an impediment between ethnic Chinese in other territories and those in the mainland. Foreign-educated Chinese returning to China are therefore particularly attractive hires.

The availability of talent can also vary by speciality. For example, China has ample audit professionals but is lacking in business development talent.

Particular challenges for Chinese staff include adapting to the matrix system of management, which many foreign banks use to operate. This model does not rely on a direct chain of command handed down from superiors, but rather leaders building teams based on charisma and ability.

Retaining talent

Large Subsidiaries and smaller Branches may face wholly opposite problems in retaining talent. The large banks may fail to offer the work-life-balance and friendly atmosphere of the smaller banks. Smaller banks may not give staff a feeling of broad scope of work and room for progression.
For both large and small foreign banks, staff must see their work as exciting and challenging. The talent development programme needs to be closely linked to the business development plan, so the target local talent have a clear career path that is highly aligned with business growth. Such alignment will become the most convincing message to retain and motivate talent.

Employment longevity can also breed loyalty. Several foreign banks said that staff "grew up with the bank", with some staff serving for more than a decade.

Special zones could be key in retaining this talent. Qianhai has proposed a much lower personal tax rate to help attract services personnel, and the SH PFTZ also appears promising.

Special considerations

Although Chinese and Asian staff are increasingly making up the senior ranks at foreign banks, decision making is still largely vested at the Group level. Sometimes this may run counter to what actually is the best course of action on the ground.

Expatriates remain a common choice for senior positions, however, their KPI's are increasingly refined to include the development of local talent. These KPIs should be equally important as those related to business expansion if foreign banks are to secure their long term future. This needs to be enforced with strict disciplines and top executive sponsorship.

Oversight of staff can be a key issue to ensure that the banks' international standards are being met. However, at the same time, foreign banks in the survey said the Group Head Office must know when to defer to the local CEO or executives.

A cultural understanding is crucial to reaching such a mutual understanding. Having board members and executives in the home office with knowledge of China is therefore also crucial, and some foreign banks choose to have regular meetings between the regional and Group Head Office staff to foster understanding.

One banker expressed that effective integration will only fully happen with the next generation of talent. Older staff, being moulded late in life, may not be able to adjust as the younger generation. Ultimately, only time and effort will bridge the cultural gap to the greatest extent possible today and perhaps more fully tomorrow.

Increasing number of Financial Services talent in Shanghai

According to the "Blueprint for the Construction of Shanghai International Financial Centre during the 12th Five-Year Plan Period", one of the targets is to increase the number of people working in the financial services industry in Shanghai from 245,000 in 2010 to around 320,000 in 2015.

Source: "Blueprint for the Construction of Shanghai International Financial Centre during the 12th Five-Year Plan Period" announced by Shanghai Municipal Government

The Chinese government has made a number of significant policy commitments in establishing the SH PFTZ and the financial world will be closely watching developments, which could ultimately determine the fate of Shanghai as an IFC.

	2007	2008	2009	2010	2011	2012
Number of staff	31,343	27,812	32,520	36,017	42,269	44,560
Number of locally incorporated banks	29	32	37	40	40	42

Source: CBRC annual reports

6. Profitability as a KPI

Foreign banks bide their time for better returns

Most foreign banks view China as too big to ignore despite sometimes lacking sufficient returns on equity and assets. Returns often serve as a key performance indicator (KPI) for convincing the Group Head Office to delegate decision making authority to regional banking heads. Essentially, strong returns allow regional heads to secure greater autonomy.

Decision makers are being shifted toward Asia, although the process is gradual and has yet to indicate a broader shift to the East. Return on Equity ("ROE") will be the key measure in the push-and-pull between East and West. Money cuts across culture and language divides to convince Group heads that the China strategy is working.

Even if China is not generating high returns today, many foreign banks believe they must be in China to prove to their customers they are a serious international bank. A few foreign banks go so far as to say they are or intend to become Asia Pacific banks, regardless of their more Western roots.

Why so low?

Most foreign banks said that ROE was low or acceptable, with only a select few stating that returns were good. Low ROE may be in part due to the need to continuously invest in growing China operations. Many banks talk about a strategy that involves an investment period in medium and longer terms.

Simply stated, foreign banks have little option but to keep investing or to pull out entirely. Many view themselves as already having invested too large a stake to back out. For retail-focused Subsidiaries, investment comes in the form of continually opening branches and often branches must be brought into a break-even position one at a time. Banks across segments are investing billions of RMB in their China operations.

ROE is low in part because of the regulatory burden. Foreign banks contend that they must strive even more than domestic banks, which have closer relationships with regulators, to comply with financial rules. Strict requirements on loan-to-deposit and foreign debt quota are chief complaints as to why it is difficult to boost ROE.

Increasing ROE

Taking Greater China into account, ROE is far better than in simply the mainland. Many foreign banks consider the combined ROE for Hong Kong and Singapore when viewing the mainland, in which case the returns are far healthier.

Both Singapore and Hong Kong benefit from the foreign bank's mainland presence and the referrals that it generates. A few foreign banks, particularly those Branches, said they book revenue when possible in Hong Kong or Singapore in view of regulatory constraints.

Some foreign banks say that it's time to see better returns after years of investment, while others are still preparing for the day markets are deregulated. One foreign bank stated that without far deeper deregulation, there is not much it can do to boost ROE and must take the growth that comes naturally.

Some foreign banks qualify the importance of ROE. One foreign bank said that credibility with the Group Head Office comes from the consistent support for global customer services and protocols not pure ROE as measured in the local books, as it is understood there is a necessary period of investment. Several said as long as they are not operating at a loss, Group Head Office will not push them on ROE.

Shift toward the East

For foreign banks with long-term growth aspirations in China, the stakes related to capital allocation will become higher and will require increased board and management attention.

The centre of financial power is gradually shifting East. China was admitted to the WTO more than a decade ago, but many foreign banks still complain they have not seen the full benefits. Clearly, opening is on China's terms.

To comply with prescriptive and unique regulations, foreign banks often benefit by localising their staff. This both reduces regulatory compliance costs and increases what one bank calls the "policy dividend", or the benefits of having closer relations with regulators. The cost of communication is also lower when staff are local.

As foreign banks become more localised, more Chinese are reaching higher levels of management and influence. Some foreign banks have shifted their regional heads to Hong Kong as a result.

The Group Head Offices of Western banks are unlikely to shift to Asia any time soon. Instead, competition is intraregional with Japan, Singapore, Hong Kong, China and others all competing to house the regional headquarters.

So while in the regulatory arena, China currently has the power, the bid for financial power will only come after deregulation deepens and China delivers the ROE to back up its broader economic ascendance.

Foreign banking establishments in China as of 2012

Institution / Type	Foreign banks	Wholly foreign-owned banks	Joint venture banks	Wholly foreign-owned finance companies	Total
Locally Incorporated Institutions (LII)		38	3	1	**42**
LII Branches and Subsidiaries		267	8		**275**
Foreign Bank Branches	95				**95**
Total	**95**	**305**	**11**	**1**	**412**

Source: CBRC Annual Report 2012

Foreign Bank Establishments

According to the CBRC 2012 Annual Report, foreign banks maintained presence in 59 cities of 27 provinces in China as of the end of 2012. That is 39 cities more than the number at the beginning of 2003.

Source: CBRC Annual Report 2012

Operating data for foreign banks (2008 – 2012)

	2008	2009	2010	2011	2012
Total Assets (RMB 100m)	13,448	13,492	17,423	21,535	23,804
Total Liabilities (RMB 100m)	12,028	11,818	15,569	19,431	21,249
Total Shareholder’s Equity(RMB 100m)	1,420	1,674	1,854	2,104	2,555
Profit after Tax (RMB 100m)	119.2	64.5	77.8	167.3	163.4
Liquidity Ratio	70.48%	58.83%	61.49%	69.53%	68.77%
NPL Ratio	0.83%	0.85%	0.53%	0.41%	0.52%
CAR (Locally Incorporated banks)	18.45%	21.22%	18.98%	18.83%	19.74%
Core CAR (Locally Incorporated banks)	17.83%	20.76%	18.56%	18.83%	19.25%

Source: CBRC Annual Reports

PwC Perspectives

1. The Third Plenum: New roadmap for achieving the China Dream

A year after taking office, China's new leadership led by President Xi Jinping has unveiled the much-awaited reform roadmap, which is to guide the nation's development over the next decade. This sets out far reaching changes which will shape the pace and direction of reform and will have a fundamental impact on the financial sector.

The 20,000-word roadmap – the Decision by the CPC Central Committee on Several Major Issues Concerning the Comprehensive Deepening of Reform – was adopted at the Third Plenary Session of the 18th Central Committee of the Communist Party of China (CPC) held in Beijing from 9 – 12 November 2013.

Many observers and interested parties believe this new comprehensive roadmap will bring about a new round of economic reform and will have significant implications for Chinese enterprises and foreign companies operating in and doing business with China. The roadmap also promises to accelerate reform of the financial sector in ways that are likely to specifically affect the strategy of foreign banks in China.

Financial reform

The Plenum unveiled plans to accelerate financial liberalisation measures that grant significant potential opportunities to domestic and foreign financial institutions. We expect a broad wave of deregulation, with interest rates set to be liberalised, the bond market likely to double in size and the capital account be substantially opened within five years. These macroeconomic policy changes. which we explore in subsequent sections, should not only make capital allocation more efficient, boosting the SME and private sector, but also provide the middle class with greater choices about where to put their money so they can earn a higher return and therefore spend more. This should help rebalance growth from investment to consumption and achieve the ultimate objective of more sustainable growth. Foreign banks while not the intended beneficiary, stand to reap rewards, particularly those that stay the course amid the twists and turns which will inevitably befall them as the reforms unfold.

Other reforms call for the broader opening of the capital market including a registration platform for initial public offerings, improvement to the multi-tier capital market system, promotion of equity financing, development of the bond market and raising the ratio of direct financing. A bank deposit insurance system will also be introduced to protect customer interests which is a necessary pre-cursor for the market based reform of the banking sector.

The success of the reforms and stability during the transition requires that the policy and regulatory actions of the Chinese government be carefully sequenced. The experience in other countries suggests that the road to financial reform can be a bumpy one. To stay on track, China must get the sequence of the key macroeconomic policy reforms right – first strengthen its domestic banking system, then improve capital allocation by liberalising interest rates followed by developing a functioning bond market before finally opening the capital account making the RMB convertible. The first step of reform of the domestic banks is now largely complete and now the time is ripe to continue on the journey. In the sections that follow we will look at each of these next steps which provide the macro framework for reform and then turn to some of the other important regulatory changes China must make on the way, but before doing so we complete the picture of some of the other decisions in Third Plenum which will have implications for foreign bank's strategies.

State Owned Enterprises and the private sector

The Plenum outlined changes which will have fundamental implications for the ownership and role of SOEs in the economy and opens and deepens the scope for involvement of private capital in many more sectors. According to the roadmap, different forms of ownership that cross-hold shares to create greater "mixed ownerships" are encouraged among SOEs. It calls for SOEs to transform themselves into "national capital investment companies" (NCICs), whose main tasks are to focus on economic sectors crucial to national security, and to provide public services, develop strategic industries, protect the ecological environment and support technological advancement.

It states that projects run by the NCICs should allow private enterprises to own shares in them. The monopoly sectors run by the NCICs also need to undertake reform measures to separate government functions from enterprise, and work to bring in competition. According to the roadmap, "all forms of administrative monopolies should be abolished".

These changes will benefit the private sector by allowing privately-owned enterprises access to areas previously off limits to them. Many new business opportunities, such as corporate restructuring, mergers and acquisitions and project investments, are likely to arise. Provincial SOEs looks set to be unleashed, this will create opportunities for the banks that service them or who finance their restructuring.

The Plenum introduces a number of changes to reinforce a further leveling of the playing field for private enterprises particularly small-and-medium-sized enterprises. The potential for reduced influence from large SOEs in sectors that open up will create a pivotal change for banks.

We have noted increased competition amongst foreign banks particularly for larger private companies and those that are well placed to consolidate their respective sectors. Domestic banks have been focusing on this area for some time and will have to adapt to risk based pricing, This may create competitive advantages for foreign banks with the right skills and focus.

Rebalancing customer segmentation to SMEs/private companies

The change in policy emphasis with respect to SOEs in China will have a number of implications for foreign banks. At first sight it might appear that the SOE sector may be de-emphasised, however, our discussions with a number of savvy corporate investors indicate that they are looking afresh at regional and provincial SOEs and this may well create opportunities for banks to work with them in the restructuring of these businesses.

Conclusion

China's leadership has clearly demonstrated a firm commitment to continuous reform and opening its economy. The objectives and approaches identified are a result of numerous fact-finding missions by the senior leaders and through close consultation and compromise with all relevant stakeholders.

The scale of the new round of reform will be enormous as the Chinese government intends to adopt a holistic approach to address the needs of the entire economic system, political system, cultural system, social system as well as the environmental system. But the Chinese leadership has expressed its confidence in dealing with the challenges and institutional barriers it may face and delivering the outcomes as planned in the roadmap.

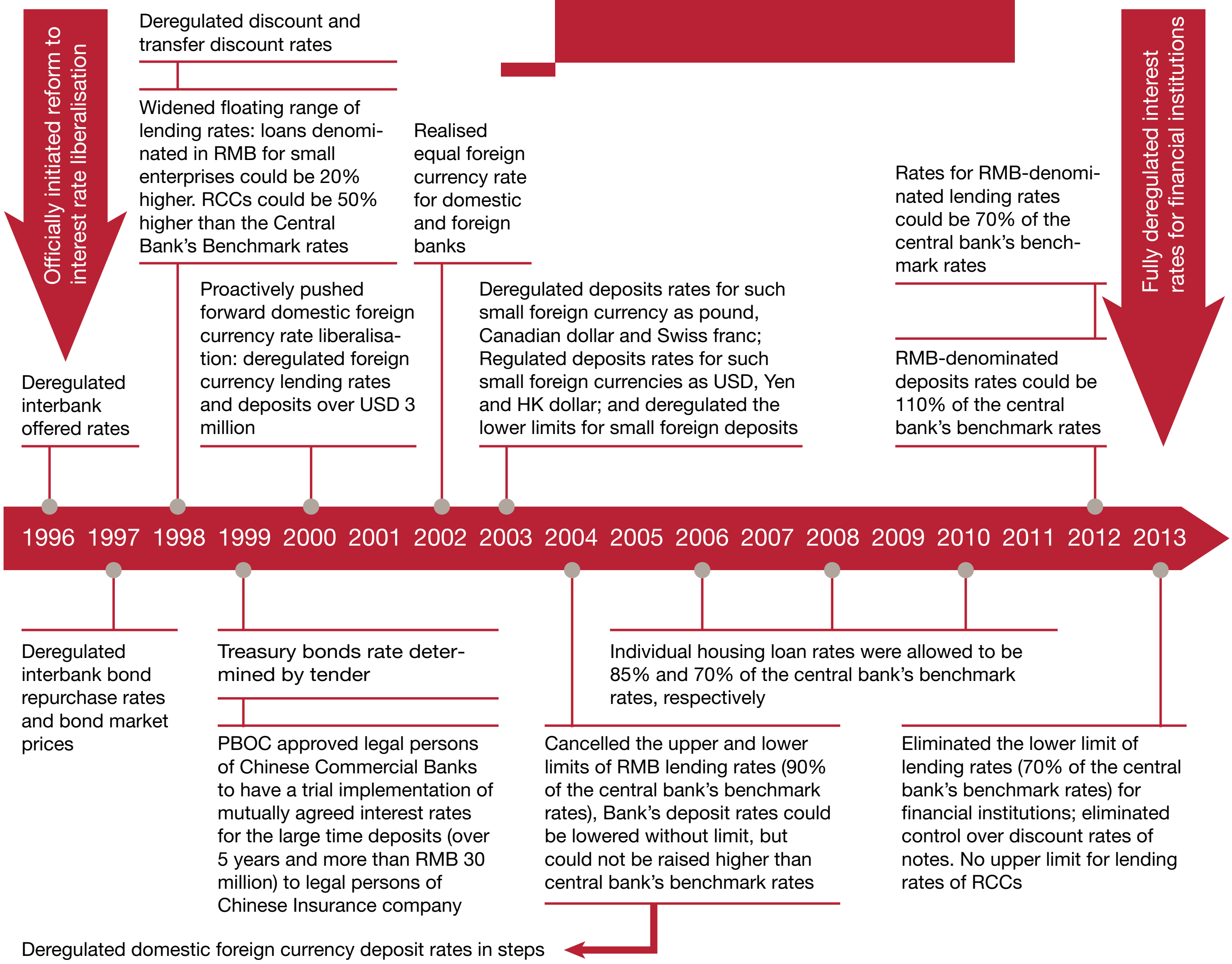
In the coming months, we expect that more detailed implementation plans will be discussed and released, with many legal changes to be approved by the National People's Congress in March 2014.

2. Interest rate liberalisation and development of the bond market

Introduction

China's steady approach towards a more liberalised lending and deposit rate regime accelerated in 2013, achieving several important milestones. Most notably, the PBOC eliminated the floor on lending rates, while committing to do the same to the ceiling on deposit rates. The Third Plenum provided additional colour as to how this process will be conducted.

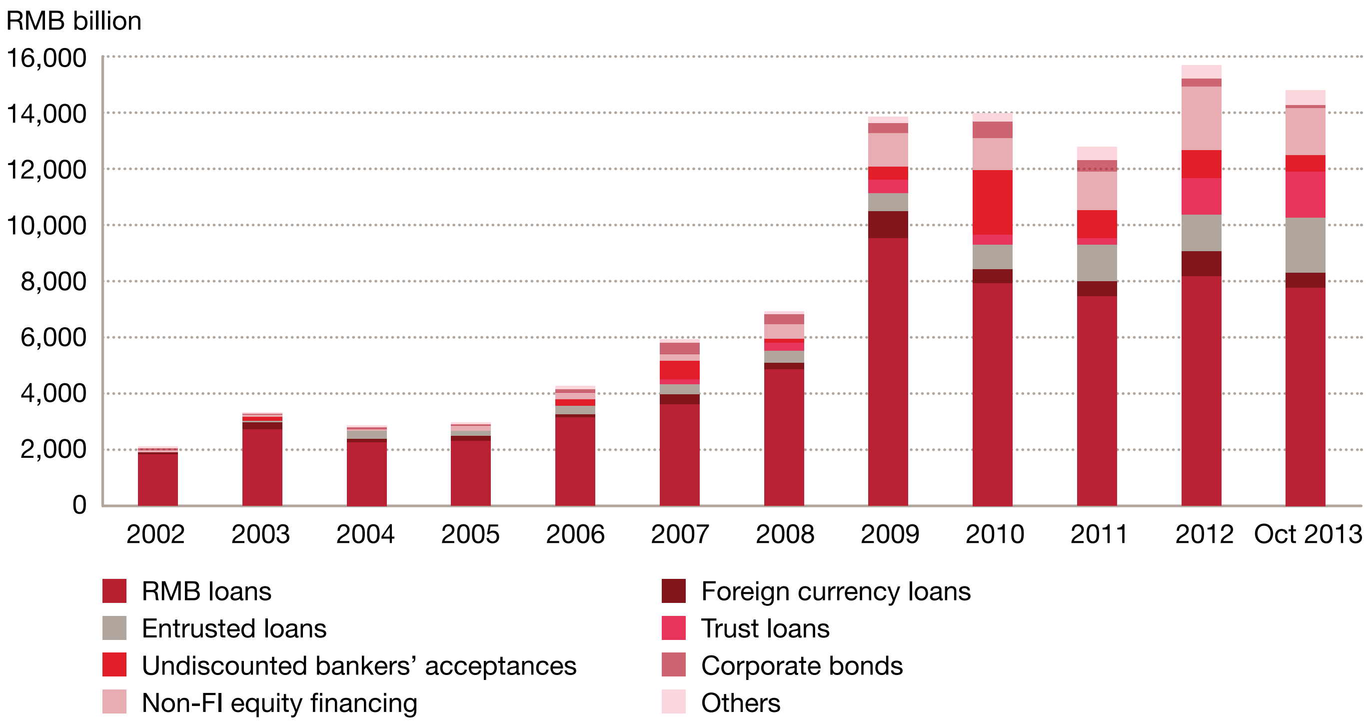
China's interest rate reform to date



Such market based reforms are imperative if China is to achieve its aspirations to improve allocation of capital and support sustainable growth. The present system that has served China's reform to date has meant that depositors have received lower interest on their savings than they otherwise would and this cheap funding has largely flowed to state owned enterprise. The current deposit base in China stands at RMB 101.5 trillion, of which approximately 45% are personal deposits and the remainder corporate deposits. Liberalising interest rates will put more cash in the hands of depositors; 2% of GDP for every 1% increase in rates which accounts for approximately RMB 1.1 trillion additional cash annually to all personal and corporate depositors, a significant boost to the economy.

Powerful market forces in recent years have pushed China to the edge of the regulatory frontier as the needs of borrowers and investors grow more diverse. The most obvious example of this is the rapid emergence of China's shadow banking sector, which by some estimates has grown to as much as 50% of the assets in the domestic banking system.

China's total social financing composition (2002 to October 2013)



Source: PBOC

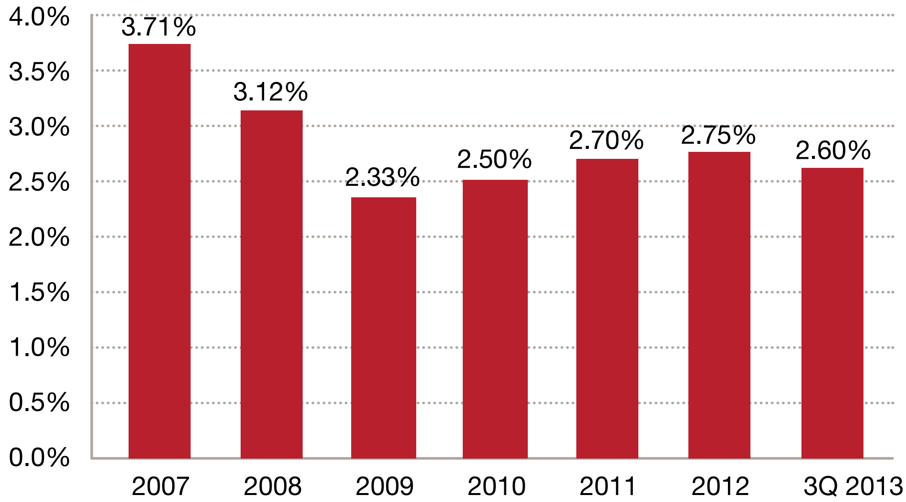
In even the most developed economies, government intervention in financial markets occurs regularly, in order to achieve near-term policy objectives. The market forces in China discussed above, however, have gained sufficient momentum that the question regarding the acceleration of interest rate liberalisation by the Chinese government is a matter of "not if, but when" – and how.

Key strategic considerations and opportunities

While China continues its financial reform, the ability for banks to identify changing customer needs and respond with a successful strategy has never been greater. We have seen examples of innovative models in the SME and credit card sectors, where foreign banks partnered with domestic banks to identify emerging customer needs and leveraged their own strengths in execution to capitalise on the opportunity.

An obvious, albeit perhaps overly simplified, harbinger of the challenges that will be faced by both domestic and foreign banks operating in China is the shrinking RMB net interest margin. This has begun to occur over the past several years. This fact, notwithstanding, a number of the foreign banks included in our survey strongly believe that interest rate liberalisation is critical to China's continued economic development and enabling its banking system to evolve.

Bank's net interest margin in China (2007 to 3rd quarter 2013)



Source: CBRC

While this pressure will continue there are reasons to believe that the impact may not be as great as some are predicting. The shadow banking sector charges punitive rates to SMEs that are forced to borrow outside the traditional banking sector. Interest rate liberalisation will force banks to look for new sources of margin and many will look to the better quality SME borrowers and new customers in the service sector which is less capital intensive. This will increase the efficiency of capital allocation to this sector bringing the better borrowers into the regulated financial sector and provide an impetus for growth. While the funding mix of the SME sector is hard to pin down, an example of the scope of the possible shift lies in the RMB 18 trillion of fixed asset spending in the year to June 2013. RMB 3.7 trillion of this was reportedly related to property development and much of this is currently funded through shadow banking. This points to a sizeable portion of funding for which the pricing is opaque and expensive.

Foreign banks stand to benefit from interest rate liberalisation in several ways, firstly it plays to their strengths of pricing risk, it enables them to deploy interest rate risk management products and finally plays to their strengths of managing liquidity risks.

During the liberalisation process there will be bumps as the process unfolds and corrective measures need to be applied. In the middle and at the end of 2013 we saw a spike in interbank rates as the PBOC sought to test the market's reliance on short term funding. Going forward all banks, foreign institutions included will need to focus on liquidity.

In order for banks in China to effectively manage the accelerating pace of interest rate liberalisation, we believe that key actions in a number of interdependent areas must occur.

- Asset-liability management

  Existing risk management practices, particularly with respect to interest rate risk, must evolve into more mature asset-liability management ("ALM") processes – integrated into banks' governance, business activities, and operations – to enable them to effectively manage more fluid and less predictable balance sheet interest rate and liquidity risk profiles. Domestic banks, having recently implemented interest rate, liquidity risk management and capital rules issued by the CBRC must now leverage these to develop integrated ALM processes to effectively manage more complex risks and efficiently price their products to maximize their quality of earnings, through more efficient use of capital. Most foreign banks operating in China have a distinct advantage over domestic banks, as they are already working with relatively mature global ALM processes and governance.

- Financial products

  As interest rate liberalisation accelerates, the demand for a broader range of financial products will come from customers and banks that need to manage more dynamic risk profiles. As illustrated by the rapid development of the shadow banking sector, the scale and pace of change must occur in an orderly and well-regulated manner. The timing and management of the supply and demand of new products will be a critical challenge for the regulators.

  This process has already begun, but it needs to accelerate. By way of example, complex interest rate risk profiles cannot be effectively or efficiently managed by funded products alone. A market for derivatives products beyond financial futures will need to develop for banks and their clients to accommodate risk management complexities, such as optionality, and the varied tenors of their risk exposures. Of course, an appropriate balance must be struck between the need to ensure the availability of reasonably adequate products (some will always want more) and the need to restrict the complexity of products, so that their risks are both transparent and comfortably managed – one lesson learned from the global financial crisis.

  Again, foreign banks will be able to leverage their experience across global financial markets but will still be constrained, as a group, by their relatively small stock of capital and what many still consider to be an inordinately slow product approval process. A number of banks in our survey, however, expressed the desire to create more distinctive products, either through attributes or pricing, that provide them with unique market opportunities. Many also continue to discuss plans to develop more fee-based business, particularly in the wealth management and cash management areas.

- Financial market infrastructure

In light of China's future financial product needs, market infrastructure must exist to ensure that markets are well-regulated, sufficiently transparent and orderly, and support effective risk management. Although key capabilities such as: price quotes and related trade information, clearing and settlement, and custody currently exist today, the depth of the market must be increased and the conduct formalised to achieve the efficient pricing needed. In particular to meet the financial product development needs stated above, the current capabilities must be "gapped" with those required to accommodate future customer needs, product attributes and volume, as well as regulatory requirements. This will necessarily be an iterative process, as new processes and systems must be developed, tested, and implemented. Another issue that must be addressed is that many of these financial market infrastructure elements are most efficiently, profitably, and effectively performed (not to mention better regulated) in scale. Currently, many of these are fragmented across China's financial services industry. Therefore, regulators might consider some form of consolidation in tandem with the iterative development process.

Foreign banks are not likely to be permitted to have significant involvement with any of the "core" elements of China's financial market infrastructure. They may, however, have opportunities to offer custody services for products in which specific banks did not have the scale to justify creating their own. Similarly, they may be able to develop an ABS servicing platform for smaller issuers or (fully aware of the lessons of the global financial crisis and the need to manage maturity mismatches) sponsor some form of multi-user ABS conduit. Other areas of potential opportunity include risk management solutions around specific portfolios that require bespoke hedging instruments or those not available in the market. These solutions could include hedge designation, valuation, effectiveness testing, and accounting journal entries.

Regardless of its form or timing, the effects of interest rate liberalisation in China will be pervasive, affecting both domestic and foreign banks. While many foreign banks still consider themselves constrained by different regulatory standards than those subject to which domestic banks are subject to, foreign banks appear poised to benefit from incremental opportunities to improve their performance and increase the value of their franchises in China.

Expected developments in the near term

In order to maintain the stability of the financial system, a number of structural reforms are necessary prior to liberalisation. The more recent reforms, namely the establishment of a prime lending rate and issuing certificates of deposit, focus on gradually implementing market pricing.

Chinese regulators have identified specific near-term actions that they will take to liberalise interest rates, such as the recent launching of the Loan Prime Rate mechanism to set a market-based lending rate benchmark, based on a daily consensus among a panel of nine domestic commercial banks. Going forward, they have clearly stated that they will proceed under a balanced approach as they address the more challenging area of the ceiling on deposit rates.

In December 2013, the PBOC permitted banks to issue large-denomination, negotiable certificates of deposit. The duration of these certificates range from one month to three years. The interest rate on the new instruments will be determined by the market, which will provide a clearer picture of the cost of capital in a market-driven environment. In international markets, three month interbank overnight rates (in this case, SHIBOR), serve as the underlying reference point for pricing certificates of deposit. Bond market reforms and deepening will also support the pricing of a market driven yield curve.

Outside of market pricing, the Chinese government intends to enhance the stability of the financial system through the establishment of a deposit insurance scheme. As at November 2013, commercial banks in China were providing feedback on a preliminary set of rules outlining the structure of such a system.

Government efforts include not only policy changes but also initiatives intended to support the continued development of China's broader financial markets. These initiatives include the creation of offshore RMB markets, the emergence of ABS, the pending renewal of trading in Chinese treasury futures after an 18-year hiatus, the development of a loan trading platform for the inter-bank market, and establishment of the SH PFTZ. We return to some of these changes in the sections that follow.

A critical component of reform is the deepening of long term financing and the development of transparent and efficient pricing of credit in capital markets, which is only possible with significantly higher levels of liquidity. The continued accumulation of debt by local government financing vehicles, whilst possibly manageable, reflects the need for alternative, longer term sources of funding which are subject to market pricing. China has witnessed the largest migration in history from the countryside to the cities, creating a massive demand for infrastructure. Yet the absence of long-term financing instruments means projects have had to rely on bank loans, resulting in a big mismatch between the payback period of the projects and the maturities of the loans. Beijing is speeding up the development of China's bond market, and we expect the expansion of municipal and corporate bonds to double the size of the domestic bond market within five years.

Over the past decade, China's bond market has experienced significant development and has grown to be the second largest in Asia. However, its bond markets remain small in comparison to the size of the economy, the market is still dominated by treasuries and a narrow group of largely state owned and policy issuers and the approval process for new issuers has been slow. China's debt capital market is governed by a large number of regulatory bodies, including PBOC, CBRC, CSRC, the quasi-governmental National Association of Financial Market Institutional Investors (NAFMII), NDRC and MOF. In many cases, companies require approval by more than one regulator to issue bonds, resulting in time-consuming, repetitive and unclear procedures.

The trading volume of the bond market is also very low, because the majority of bonds are held to maturity by domestic investors, this impacts the liquidity and efficiency of the market.

The Plenum referred to above reaffirms China's clear intention to reform and build more liquid debt markets. The bond markets provide an efficient source of long term funding which China needs and the pace of development will increase. The first stage of this is allowing more issuers by permitting market forces to determine the types and pace of issuers, durations and over time innovations in the types of products. An essential component to the depth of the market will also be to encourage institutional investors, particularly insurers and national pensions to increase their participation.

While foreign banks have struggled to play a significant role in the issuance and trading of debt by the larger SOEs that have accessed the market to date, the reforms create the potential for a wider issuance by provincial level SOEs and large and medium sized private companies, creating opportunities for those foreign banks that have started to penetrate these markets. A number of foreign banks also see opportunities, over time, for ABS markets to open.

Acceleration of the development of the bond market

3. Internationalisation of the RMB

Introduction

More than 900 financial institutions in over 70 countries are already doing business in the RMB but the currency is used far less internationally than one would expect. This is now changing. Since June 2010, corporations anywhere in the world can settle in RMB and the volumes are increasing.

More than 10% of China's cross-border trade is now settled in RMB. In Hong Kong, 'Dim Sum' bonds and RMB IPOs are really taking off. The RMB is used for retail business in Singapore, and there's active FX trading around the RMB in London.

Both Chinese and foreign banks involved in global trade with China will feel the impact of the RMB internationalisation on their business:

- Chinese banks see this as a strategic opportunity to follow their clients abroad and develop their international payments clearing business;
- Foreign banks see this as a growth opportunity, as foreign companies now need to use and invest the RMB they earn;
- Banks globally will see payments to China, of which over 90% are currently in USD, gradually shift to RMB.

Chinese policy and the future of RMB

China continues to accelerate regulatory reforms to liberalise its currency and nations throughout the world have been embracing this fast pace of reform by priming their financial markets to take advantage of rapid RMB growth. The pace of this change will be governed to a large degree by the ability of the market to manage the change without risking instability in the currency and ultimately the financial system.

The PBOC is also trying to pilot RMB cross-border usage through current account transactions and direct investment in the SH PFTZ as well as implementing a pilot program of negotiable certificates of deposits among qualified financial institutions in the SH PFTZ. Deposit rate liberalisation is expected to accelerate.

These initiatives will require China to fundamentally restructure its system of capital controls and further open up its domestic financial markets. To this end, various regulators such as the PBOC, the State Administration of Foreign Exchange (SAFE), and the Ministry of Commerce and the National Development and Reform Commission, among others, will need to coordinate among themselves to develop concrete implementation plans. The new measures are also intended to curb speculation on the currency.

There is some market sentiment that China's exchange rate is reaching equilibrium as its surplus had reached close to 2.3% of GDP in 2012. We are now at a point where capital flow might fluctuate further, thus policy makers must ensure the appropriate mechanisms are in place to manage the expected volatility of the currency.

International usage of the RMB continues to develop, but this has accelerated dramatically in recent years. However there are many benefits to be achieved through the liberalisation and promotion of the use of RMB beyond China's borders. Chinese companies, in particular SMEs, can use RMB for cross-border trade instead of a foreign currency to avoid FX costs and exchange risk. Foreign companies paying in RMB can do business with more companies in China, thus increasing the overall size of trade.

Large companies can manage their RMB more globally and over time diversify their assets and protect against depreciation of one currency. From a macroeconomic point of view a third global currency could be beneficial – particularly one from Asia, in which countries could hold their reserves, especially as trade between Asian countries increases. During the recent financial crisis, banks in some Asian economies that use USD experienced liquidity issues because of the increased cost of funding. While there is also considerable anticipation about the importance of the role of the RMB as a reserve currency, this will require the capital account to be open and is not necessarily consistent with China's short-term objectives.

Expected developments

The recent developments in China, Asia Pacific and Europe demonstrate the strong willingness of many nations to support the continuous development of the RMB as a truly global currency. China is the second largest economy in the world, so it comes as no surprise that there has been a rapid growth of the RMB as a payment currency and that it is increasingly accepted as a major currency in world trade. Major financial markets also seem united in their desire to promote and participate in this development.

It is clear that there are a number of hurdles China's regulators have to address before achieving full convertibility of the RMB. However, as can be seen from the recent international developments of the RMB as a global currency, this RMB growth story is showing no signs of slowing, and it seems to be only a matter of time before the goal of the RMB becoming a widely used global currency is achieved. In the summer of 2013, China announced plans to allow banks in Hong Kong to lend RMB to companies in Shenzhen, opening that city financially to the rest of the world. Following this step, the reforms have only continued with the pilot of the SH PFTZ launching in September 2013 which is expected to create further opportunities beyond just being a conduit for the RMB but also increase cross-border trade and capital flows across a wide range of industries and sectors. The expectation is that if financial opening works in these trials, they will be expanded relatively rapidly, first perhaps in other select markets as part of an expanded trial and then nationally.

A key question banks and companies should ask themselves is whether they are positioning themselves effectively to benefit from the growth of the RMB both onshore and offshore.

Internationalisation of the RMB – opportunities for foreign banks

Many banks are building up a RMB settlement and payments capability, on their own or by opening RMB accounts with banks in Hong Kong or China, creating new business for banks offering accounts, liquidity reporting and clearing services.

RMB trade settlements are mainly substitution – the same payment in another currency.

For banks individually this may mean an increase or a loss of business. What is increasingly clear is that Chinese and foreign banks are likely to increase their market share, and we may over time see a loss in intermediary bank's revenue if payments shift from USD to more direct RMB clearing in Hong Kong and China. On the positive side, inbound settlement in RMB could reach more companies in China, thus increasing the breadth of the customer base and overall trade.

On the FX side, banks are already seeing a reduction in revenue on trade related FX from Chinese companies, but now foreign companies need to buy RMB, as well as hedge against currency risk. A significant RMB opportunity lies in FX trading, developing a global market share from currently less than 1% to say 5% by 2020. Foreign banks will need to develop their RMB FX trading strategy to ensure they capture a share of this market.

Currently the RMB is not having a big impact on trade finance. We are mainly seeing redenomination of the same underlying trade, and RMB volumes will remain relatively small unless commodities are priced in RMB.

Another significant opportunity is from RMB investments and securities services, following gradual policy liberalisation in bonds and equities, as more investors outside China holding RMB will seek returns beyond currency appreciation, driving product innovation in this space. We are seeing this already with RMB IPOs and dim sum bonds but this is only the tip of the iceberg.

4. The China (Shanghai) Pilot Free Trade Zone: A new era of reform and opening in China

On 29 September, 2013, the Chinese government formally established the China (Shanghai) Pilot Free Trade Zone (SH PFTZ) compromised of four existing free trade zones. As of December 2013, more than 1,400 companies (including 12 foreign banks) had registered in the SH PFTZ with a further 6,000 companies in the process of applying in sectors ranging from trading, banking, leasing, logistics, and e-commerce.

The SH PFTZ has outlined a slew of initiatives that makes it attractive to businesses operating in the shipping, trading, insurance, healthcare, entertainment and education sectors, all of which will continue to incentivise foreign banks to cater to their growing and sophisticated banking and financing needs, including but not limited to: trade financing, factoring, leasing, commodities, shipping and derivatives trading among others. Its agenda is broad and is largely aimed at reducing administrative intervention to cross-border capital flows and the movement of goods.

It is intended to create a financial market that is more investor friendly and gradually aligned with open market practices, in order to continue attracting investment to China and serve as an incubator for a broad wave of deregulation discussed earlier. The SH PFTZ will play a key role in ensuring the sustainability of China's economic development as it transitions to a more consumption-based model.

In terms of reforming the licencing system, foreign banks in the SH PFTZ are expected to be gradually granted licences to offer new cross-border financial products related to commodity trade finance, supply chain financing, and broader financial support to modern service industries. Further, the development of financing for the shipping industry, complemented by the ability to engage in trading freight index derivatives, as a way of promoting Shanghai's international shipping centre plays to the strengths of foreign banks that have experience with specialised industry lending and derivatives.

It is worth noting that domestic private investors are also allowed to participate in the SH PFTZ, through methods including private banking, financial leasing and consumer financing (independent investment or joint investment with foreign capital). Foreign banks with their historic expertise in these segments coupled with their competitive advantage operating regionally and globally will be set to benefit.

Role of the SH PFTZ in China's financial reform

The benefits of SH PFTZ reforms for the financial sector are numerous.

Ease of simply conducting business by foreign banks should improve considerably in the SH PFTZ. They will be allowed to directly establish a branch, wholly-owned subsidiary or majority-controlled subsidiary with Chinese business partners in the region within a shorter time period. This will reduce the otherwise lengthy approval processes, significantly easing foreign entry. Currently, foreign lenders are expected to have operated representative offices for at least two years before they can open a branch in mainland China, and even then only after having met strict criteria.

Going beyond finance, the relaxation of financial and foreign exchange policies could improve regional treasury management for non-financial MNCs that have placed their regional headquarters in China. Currently, regional headquarters in China are subject to strict administrative controls in the areas of funds management and capital project funding, in both RMB and other currencies, for their Chinese subsidiaries, whose functional currency may be RMB and or another depending on the circumstances.

Overseas companies' cross-border treasury management will be further enhanced if policies both promoting RMB convertibility and easing administrative controls are relaxed. This would encourage the establishment of regional treasury and settlement centres. The result could push China a step closer to its goal of attracting more MNCs to establish regional or global headquarters in China, another indication of expanding global economic influence.

The biggest step taken so far by the PBOC to support the SH PFTZ is to allow individuals to invest in overseas markets. Those investments will no longer be restricted by quotas under the qualified domestic institutional investor ("QDII") program. Foreign financial institutions in the SH PFTZ with a free trade account (FTA) can also invest or trade in Shanghai Stock Exchange or Shanghai Future Exchange and they may be exempt from quotas under the qualified foreign institutional investor system ("QFII"). The parent of a company domiciled in the SH PFTZ will be allowed to issue RMB bond in the domestic capital market, pursuant to relevant laws and regulations. However, it appears foreign currency borrowing from overseas will still be subject to quota management. One of the key objectives of SH PFTZ is to further promote the international use of the RMB. According to the PBOC guidance, the procedures for cross-border RMB settlement within the SH PFTZ will be significantly simplified. Foreign banks and other companies can borrow RMB from overseas but the proceeds cannot be used to invest in marketable securities, derivative products or entrusted loans.

The PBOC will also remove the interest rate ceiling on foreign currency deposits "at an appropriate time". This guidance has provided much clearer direction, from a regulatory perspective and detailed implementation rules are expected to be released in February 2014.

A competitive regulatory and tax environment

Key features of the tax policies and incentives in the SH PFTZ are intended to support innovative business models. For instance, under the plan, financial leasing companies in the SH PFTZ are granted an export value-added tax (VAT) refund, a policy previously only applicable to the domestic companies in the Tianjin Binhai New District. Investors injecting capital in the form of non-monetary assets into their companies in the SH PFTZ may average their asset appreciation premium over a period of five years for corporate income tax (CIT) and individual income tax (IIT) purposes.

Professionals may enjoy preferential IIT treatment on gains derived from awards under share-based payment schemes granted in the SH PFTZ, which is currently only available in the special region of Zhongguancun in Beijing.

In addition, industries expect more tax incentives in areas including offshore business and overseas equity investments from the central government in subsequent announcements. Local incentives in the form of financial subsidies are also anticipated.

What are the potential opportunities for foreign banks?

We noticed various reactions from our survey with 8 foreign banks expressed their interest in establishing a branch in SH PFTZ and 22 banks taking a "wait-and-see" approach.

The PBOC guidelines are considered as "very conservative" blueprint for the SH PFTZ, as it does not make any of the progress in interest rate liberalisation, free currency convertibility and foreign debt quotas, that many foreign banks are expecting to see. However, the guidelines do provide a clearer overview of what activities foreign banks can conduct in the SH PFTZ. We believe there are a number of opportunities for foreign banks operating in the SH PFTZ:

- We expect that there would be significant increase in the volume of cross-border trade and settlement through the SH PFTZ, with foreign banks better able to leverage their global network to increase both NIM and fee income.
- Offshore RMB borrowing in the SH PFTZ is not subject to any quota management. Foreign banks can utilise this low cost RMB funding to finance their lending businesses in the SH PFTZ, which is likely to generate higher NIM and profit. Similarly, companies in the SH PFTZ may also borrow RMB from overseas entities of foreign banks.
- Foreign banks can expand their financial advisory and wealth management businesses in the SH PFTZ by facilitating PRC individuals' investment overseas, as well as foreign individual and institutional investors' access to China's capital markets.
- Foreign banks can provide cash management services to its MNC customers in the SH PFTZ to further enhance their group treasury functions, especially for RMB treasury management.
- Foreign banks with expertise in trade financing, leasing and factoring will be able to offer these solutions to their clients who will be incentivised to set up logistics hubs in the SH PFTZ due to the reforms.
- Foreign banks can align their teams in other overseas financial markets and international product experts to help their customers in the SH PFTZ better manage their financial risks and hedge their open positions within the SH PFTZ or in overseas markets.
- We believe there will be gradual relaxation in regulatory supervision on transactions between the SH PFTZ and other parts of mainland China, through use of FTAs.

We believe foreign banks should evaluate the potential of the guidelines and continue to monitor this space closely, identify the opportunities relevant to them and start to make necessary preparations to convert these opportunities. For those foreign banks which responded with a "wait-and-see" approach during our interview, it is time for them to make a decision whether to establish a branch in the SH PFTZ or not.

Some observers believe that, with the implementation of SH PFTZ, Shanghai could potentially compete fully with Hong Kong. However, it should be noted that Shanghai would continue to lack the deep pool of financial talent and a well-established legal and financial system. Further, Hong Kong would still benefit from its favourable income tax system and faster access to information. We are of the view that the development in the SH PFTZ will not impose a threat to Hong Kong's position in the near future, but strengthen Hong Kong's role as a major offshore RMB centre, as investors will be able to access more RMB products through the SH PFTZ.

5. Other regulatory reforms

In addition to the macro policy changes brought in by the Third Plenum, foreign banks face a raft of other policy shifts which create opportunities. We explore some of these below.

Central clearing of derivatives

The People's Bank of China (PBOC) has recently discussed draft guidance on the establishment and operation of a central counterparty (CCP) for standardised OTC derivatives with a number of large domestic banks.

This draft guidance states that the Shanghai Clearing House (SCH), ultimately majority-owned by the PBOC and Ministry of Finance, will be designated as the first OTC derivatives CCP in China. The SCH currently clears and settles trades of bond and funding products in China's inter-bank bond and funding market. These trades are initially recorded in the China Foreign Exchange Trading System (CFETS), through which trades in OTC derivatives will also be processed for clearing and settlement. The PBOC has indicated that the initial OTC derivatives to be made available will be "vanilla" interest rates swaps, with a tenor up to five years and three reference floating rates – 7 – day Repo, overnight SHIBOR and 3-month SHIBOR. Use of the SCH to clear and settle these products, with limited exceptions, are expected to be mandatory starting 1 March 2014.

In July 2013, the China Banking Regulatory Commission (CBRC) issued the Notice on Measurement Rules of Capital Requirements for Bank Exposures to Central Counterparties. These rules are forward-looking in that, among other things, they contemplate the establishment of other CCPs and minimum standards for a CCP to be subject to these rules (i.e. a qualified CCP) . Generally, risk weightings are established for CCP trade exposures (2%) and CCP funded default fund contributions ((2%*trade exposure)+(1,250%*pre-funded default fund contribution), with a minimum level of 20% of trade exposure).

While this approach is consistent with the New Basel Accord, the rules on default fund risk weightings proposed in other countries have become the subject of debate, with many concerned parties asserting that the capital cost far exceeds the related risk (i.e. they actually create an incentive to conduct non-centrally cleared trades). As banks in China continue to model the capital requirements of their OTC derivatives activities, in conjunction with the CBRC, these rules may be refined to ensure that they provide the appropriate incentives for banks to use qualified CCPs for the clearing and settlement of OTC derivatives.

Broadly, we believe that the introduction of centrally-cleared OTC derivatives will serve as a catalyst for the more rapid expansion of this market in China. As domestic refinements progress, and the global debates around the consistency of CCP regimes in different countries and appropriate default fund capital levels are resolved, the approval of centrally cleared OTC derivatives by the PBOC and CBRC should become more timely and predictable.

While the OTC derivative activities of foreign banks in China will be constrained by their capital levels, relative to those of the large domestic banks, we believe that a more rapidly expanding OTC derivatives market in China will provide foreign banks with both market opportunities and efficiencies. At PwC, we view this process as follows:

- *OTC derivative product development and approval*

  As discussed in the Strategy section of the survey findings, the economic forces emerging around China's increasing pace of interest rate liberalisation will make the availability of OTC derivatives with a range of attributes and tenors imperative to enable banks and companies in the real economy to effectively manage interest rate risk. Executives managing the China operations of large global banking groups with deep OTC derivatives experience could soon find themselves in more meaningful dialogue with the PBOC and CBRC regarding OTC derivative product development and approval. While the primary focus of these regulators is supporting the government's economic policy objectives and the soundness of China's banking system, lessons learned elsewhere may have increased relevance in an environment of more rapid change. Foreign banks in China have had precious few opportunities to genuinely form more substantive relationships with local regulators to date, but they may have one here.

- *Changing market needs*

  While domestic banks in China will have access to the same centrally-cleared OTC derivative products as foreign banks, a number of foreign banks have had more experience working with their customers to develop funding and risk management solutions that both address the increasingly complex needs of their customers and the profitability of the bank. This will give these banks a competitive advantage with the most progressive and sophisticated customers, who can discern the real impact of seemingly subtle differences in proposed funding and risk management solutions that involve OTC derivatives.

- *Home country regulation and oversight*

  Notwithstanding the ongoing global debates over certain aspects of implementing OTC derivative CCP regimes, which will surely be worked through over time, the use of CCPs to clear and settle OTC derivative products in China should ultimately provide capital benefits for the home country Group or bank, as appropriate. Further, depending on their specific Group product development and control guidelines, the existence of an OTC derivative CCP regime in China may make the internal process of new product approval less cumbersome for some foreign banks in China, as new centrally cleared OTC derivatives are introduced on CFETS.

Basel III: Guidelines for implementation in China

The banking industry's pace of Basel implementation in China has picked up in the last year with the China Banking Regulatory Commission (CBRC) new capital rules coming into effect in 2013 and a few detailed regulatory guidelines being published.

As expected by both the Basel framework and the CBRC new capital rules, the Basel implementation not only aims to create a more resilient banking industry and an approach to calculate the capital ratios that are consistent across different banks, but also encourages the banks to enhance risk management and capital management capabilities.

Banks are seeking to do this through more robust and effective governance structure, managing budgetary processes with the consideration of capital charges that fit their risk appetite, direct strategic allocation of capital, risk models and IT/data infrastructures.

Both domestic and foreign banks in China need to take actions to be not only regulatory compliant but also to be more competitive in risk management capabilities and strategy setting, including the following steps:

- Governance and risk management structure need to be reviewed and enhanced, to realise the check and balance between business development and risk management, and to take into consideration both the independence of risk controls and the efficiency of management processes.
- To ensure an effective risk management framework, a risk identification and assessment mechanism should be established and carried out on a timely basis, in order for the banks to get a comprehensive view of its risk management quality on credit risk, market risk, operational risk, and other material risks.
- Risk appetite needs to be defined at the board level and be implemented throughout the entire organisation. This will need to include a clearly formulated risk appetite statement and set of indicators for balancing growth, profitability and risk, and achieving the long-term strategic objectives of the bank. These should be reviewed annually and should consider asset-growth targets and trading limits.
- Banks under Basel III will have to meet the Capital Adequacy Ratio (CAR) requirements which are much higher than earlier under Basel II. Financial budgeting and planning functions thus need to be enhanced along with effective capital planning and capital allocation processes. Capital based and risk adjusted evaluation ratios such as Economic Profit (EP) and Risk Adjusted Return on Capital (RAROC) are usually used to improve the risk-return of the bank's portfolio, and to optimise the value added to the shareholder.
- Risk differentiation of borrowers and facilities using the Internal Rating Based (IRB) approach is one of the key initiatives recently undertaken by many banks in China. Although banks have the option of not using the IRB approach to be compliant, the benefits of IRB in risk management enhancement are widely recognised. Using the internal ratings, borrowers and facilities are differentiated to better support the credit approval decisions. Moreover, the bank can apply the risk parameters generated from the IRB approach into the management processes to enhance process efficiencies, and to achieve its risk appetite and capital management objectives.
- For those banks that have just realised the importance and benefits of Basel but have not started any substantial work, an Enterprise-wide Risk Management (ERM) and Basel planning exercise is usually the first action that a bank should take. Such a planning exercise helps the bank to get a full picture of its current risk management framework and the overall status of Basel readiness, and concludes with an implementation plan describing the roadmap as well as the actions and resources needed to be regulatory compliant within the next 3 – 5 years.

Foreign banks in China: Plan for the CBRC new capital rules.

Taking advantage of the management mechanisms, methodologies and tools from the Group Head Office, it is comparatively easier for foreign banks in China to manage risks and capital in an effective way compared to their domestic counterparts.

Further attention, however, needs to be given by foreign banks in China to the local environment, including customers, CBRC guidelines, regulatory filing requirements as well as the increasing competitiveness of domestic banks. Foreign banks should consider the following points specific to the China market:

- Risk governance and the soundness of risk management framework has been one of the key areas that the local regulator addresses when assessing the bank's overall compliance with the new capital rules. Oversight of the Board and senior management, clear definition and independence of risk management functions, and the roles of internal audit are all key elements that a foreign bank should have in place to ensure effectiveness of the risk governance structure.
- The Internal Capital Adequacy Assessment Processes (ICAAP) is another mandatory requirement of Basel and the CBRC new capital rules. A bank needs to link its capital level to its business strategy and the risks taken, and to establish routine capital planning, monitoring and stress testing processes to achieve a balance of growth, risk and return. Capital is allocated to different dimensions such as business lines, products and branches and is charged as the cost of the risks taken by different businesses when evaluating the overall performance of the business lines or branches. Capital planning and allocation are usually carried out with, and can help improve, the budgeting processes to ensure the dynamic linkage between business growth and risk.
- Stress testing is not only a regulatory filing requirement but also a useful tool for the bank's management to better understand its portfolios and the impact on risk and capital of unfavourable economic fluctuations. Foreign banks in China should pay attention to China-specific factors such as GDP growth rates, monetary and export/import policies, interest rate liberalisation as well as to the exposures that are subject to specific risks such as loans collateralised by residential and commercial properties, government platform loans, or loans to steel trading companies. Having increased rapidly, real estate prices of in China should also be closely monitored. Besides using real estate price indices as the input of stress testing scenarios, banks should also develop internal collateral evaluation methodologies in order to catch the volatility of the real estate prices and its impacts on collateralised loans on a timely basis.
- Due to the relatively smaller portfolio size and the lack of historical data, especially data on defaulted borrowers, foreign banks in China usually leverage the parent bank ratings for extending credits to their global clients in China. As the foreign banks start to build client segments with both state-owned and private Chinese companies, adapting its offshore or regional risk quantification models may not capture the risk characteristics of local borrowers and facilities. More localised rating models can help foreign banks to better differentiate their borrowers and facilities, and to better implement the risk parameters into the risk management processes. For example, the credit approval authorisation matrix can be tailored to reflect the difference of risks and capital consumption of the credit applications. Risk-based pricing taking into account the cost of capital can also be used as an important reference when making pricing decisions.
- As the CBRC implements the new capital rules with detailed guidelines and filing requirements, regulatory report filling has become increasingly complicated and time consuming. A bottom-up approach summarising report numbers from branches into the head office no longer fits the increasing filing needs. Foreign banks need a centralised data repository and automated reporting engines to enhance the efficiency and report filing quality.

Conclusion

Foreign banks in China will continue to see both the impacts and the benefits as the CBRC implements Basel related capital rules in China.

By comparison, the implementation of new measures by the domestic banks is running at a faster pace from large SOE banks and joint-stock banks to city commercial banks and rural commercial banks. Implementation of ICAAP will push domestic banks to examine their loan pricing and to prepare for interest rate liberalisation. There would be opportunities for foreign banks to compete in an industry where the foreign banks have strong industry expertise and knowledge to offer true risk pricing.

Nevertheless the foreign banks will need to seek more support from the Global Head Office to expand local risk management talent, and make changes in areas including risk governance, capital and risk management, risk quantification and stress testing, and data and IT system enhancement to remain both competitive and compliant within the local environment.

Appendices

Participants by country/ territory of origin

Bank	Country/ Territory	City
Australia and New Zealand Bank	Australia	Shanghai
Commonwealth Bank of Australia	Australia	Shanghai
National Australia Bank	Australia	Shanghai
Westpac Bank	Australia	Shanghai
Raiffeisen Bank International	Austria	Beijing
KBC Bank	Belgium	Shanghai
Bank of Montreal	Canada	Beijing
SPD Silicon Valley Bank	United States / China	Shanghai
BNP Paribas	France	Shanghai
Crédit Agricole	France	Shanghai
Commerzbank	Germany	Shanghai
Deutsche Bank	Germany	Beijing
Norddeutsche Landesbank	Germany	Shanghai
Dah Sing Bank	Hong Kong	Shenzhen
Hang Seng Bank	Hong Kong	Shanghai
Bank Mandiri	Indonesia	Shanghai
Intesa Sanpaolo Bank	Italy	Shanghai
Mizuho Corporate Bank	Japan	Shanghai
Maybank	Malaysia	Shanghai
ING Bank	Netherlands	Shanghai
Rabobank	Netherlands	Shanghai
VTB Bank	Russia	Shanghai
DBS Bank	Singapore	Shanghai
United Overseas Bank	Singapore	Shanghai
Banco Santander	Spain	Shanghai
BBVA	Spain	Shanghai
Credit Suisse	Switzerland	Beijing
UBS	Switzerland	Beijing
China Trust Commercial Bank	Taiwan	Shanghai
Barclays Bank	United Kingdom	Shanghai
HSBC Bank	United Kingdom	Shanghai
Standard Chartered Bank	United Kingdom	Shanghai
Bank of America Merrill Lynch	United States	Shanghai
Bank of New York Mellon	United States	Shanghai
Citibank	United States	Shanghai
JPMorgan Chase Bank	United States	Beijing
Wells Fargo Bank	United States	Shanghai

For detailed background of the participating banks, please refer to our website
http://www.pwccn.com/home/eng/fbic_2013.html

List of locally incorporated banks

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

Top 50 Chinese banks ranked by Tier 1 capital

Rank China	World		Tier 1 Capital $m	% Change	Assets $m	Rank
1	1	Industrial and Commercial Bank of China	160,646	14.72	2,788,906	1
2	5	China Construction Bank	137,600	15.50	2,221,435	2
3	9	Bank of China	121,504	9.29	2,015,996	4
4	10	Agricultural Bank of China	111,493	15.64	2,105,619	3
5	23	Bank of Communications	57,613	37.78	838,375	5
6	47	China Citic Bank	31,171	14.50	470,579	10
7	50	China Merchants Bank	28,868	16.34	541,847	6
8	53	Shanghai Pudong Development Bank	27,141	17.13	500,112	9
9	54	China Minsheng Banking	26,099	30.43	510,652	8
10	55	Industrial Bank	26,016	46.90	516,848	7
11	75	China Everbright Bank	17,580	22.03	362,368	11
12	97	Ping An Bank	12,225	N/A	255,411	12
13	102	Hua Xia Bank	11,362	15.35	236,711	13
14	105	Bank of Beijing	11,039	39.23	178,055	15
15	118	China Guangfa Bank	9,922	19.70	185,715	14
16	158	Bank of Shanghai	6,488	21.01	129,873	16
17	179	Bank of Jiangsu	5,424	22.92	103,376	17
18	199	Chongqing Rural Commercial Bank	4,802	15.29	68,970	19
19	212	Shanghai Rural Commercial Bank	4,366	10.17	57,547	23
20		HSBC Corp China	3,942	28.19	47,457	30
21	235	China Zheshang Bank	3,675	10.80	62,614	21
22	238	Bank of Nanjing	3,614	9.56	54,657	25
23	245	Guangzhou Rural Commercial Bank	3,557	13.31	55,239	24
24	248	Bank of Ningbo	3,482	20.09	59,386	22
25	278	Bohai Bank	3,130	20.63	75,056	18
26	279	Huishang Bank	3,114	20.63	51,546	27
27	285	Beijing Rural Commercial Bank	2,991	16.12	67,466	20
28	313	Harbin Bank	2,613	42.97	41913	31
29		Standard Chartered Bank China	2,486	9.91	26,838	39
30		The Bank of EastAsia (China)	2,337	10.12	32,904	36
31	344	Bank of Hangzhou	2,272	2.24	51,667	26
32	348	Shengjing Bank	2,262	25.46	49,794	28
33	350	Bank of Kunlun	2,254	22.96	29,382	38
34	352	Bank of Jilin	2,247	11.58	35,097	34
35	353	Bank of Tianjin	2,245	1.77	48,068	29
36	357	Bank of Suzhou	2,197	8.15	20,417	46
37	380	Bank of Chengdu	2,025	16.22	38,203	33
38	387	Shunde Rural Commercial Bank	1,978	2.82	24,530	43
39	401	Hankou Bank	1,900	47.79	25,816	41
40	413	Tianjin Rural Commercial Bank	1,826	18.78	34,142	35
41	420	Bank of Jinzhou	1,796	31.73	19,596	47
42	434	Bank of Dalian	1,699	18.33	40,827	32
43		Sumitomo Mitsui Banking Corporation China	1,632	7.64	13,380	65
44	480	Xiamen International Bank	1,435	132.77	32,840	37
45	491	Bank of Dongguan	1,386	19.81	22,254	44
46	497	Hangzhou United Rural Commercial Bank	1,352	10.24	14,464	63
47	498	Qingdao Rural Commercial Bank	1,343	N/A	16,146	59
48	501	Bank of Hebei	1,318	90.19	19,414	48
49		Mizuho Corporate Bank	1,300	6.17	12,220	70
50	513	Bank of Chongqing	1,272	25.49	24,825	42

Source: The Banker, July 2013

The American Chamber of Commerce Shanghai – Viewpoint

Industry Update : Financial Services

As China transitions from a manufacturing-based, export economy to one increasingly driven by domestic consumption, the demand for more sophisticated ways to manage financial risk is increasing. The development of China's financial services industry is increasingly important, particularly in Shanghai, which is focused on becoming an International Financial Center (IFC) by 2020.

American firms play an integral part in supporting China's financial development and have potential for further growth as China continues to internationalize the RMB for use in trade settlements and refine the derivatives market. China's vast market is attracting a global array of financial leaders, with foreign banks accounting for 12 percent of the market and recording US$2.61 billion in after tax profits in 2012. However, significant challenges remain for foreign financial companies in China.

Transparent Regulatory Development

China's financial market remains tightly controlled by national and provincial governments, and there are many areas in which regulatory policy is ambiguous, or where two or more regulatory bodies in China disagree on policy execution. Payment processing, for example, traditionally falls under the jurisdiction of the People's Bank of China (PBoC), but some aspects may also fall under the China Banking Regulatory Commission (CBRC).

A 2012 PwC report found that regulatory constraints have impeded the introduction of financial products, including commodity hedging, securitization and credit default swaps. Locally incorporated foreign banks are still awaiting China to fulfill an agreement reached at the 2012 Strategic and Economic Dialogue to allow distribution of mutual funds – a market currently only open to domestic lenders. At high level meetings with the U.S., China has supported the shared commitment of the U.S. and China to enhance openness, accord fair and equitable treatment and contribute to the reduction and elimination of discriminatory practices and market barriers. These aims could be supported by the completion of a strong U.S.-China Bilateral Investment Treaty (BIT).

National Treatment

Official regulations in China make no distinction between domestic and foreign-invested financial service providers, but foreign providers often face more challenges when seeking to expand or conduct business. For example, a newly established China branch of a U.S. commercial bank can conduct USD business in China, but must wait an additional 3 years to be licensed for RMB business. This requirement immediately limits a new branch's ability to support China-based U.S. companies, which are forced to engage Chinese banks for RMB financing.

Foreign-invested property and casualty (P&C) insurance companies face similar difficulties for branch expansion, especially concerning branch approval processes. Unlike domestic companies, foreign companies are only allowed to submit one branch request and additional requests may not be concurrent. Although the insurance sector is growing, government regulations restrict market access for foreign-invested firms to large-scale commercial risks and group life and accident insurance.

While China's bond market has achieved significant development over the past several years, no fully owned U.S. bank is permitted to underwrite Medium-Term Notes (MTN) and Commercial Papers (CP). These bonds account for 49 percent of the total outstanding notional bond market in China. China's financial market regulators have gradually been taking measures toward an issuer-driven underwriter selection and appointment process that is more consistent with advanced financial markets. U.S. banks remain locked out of this process and are not yet able to underwrite these despite their extensive, internationally recognized knowledge and experience in underwriting debt securities.

AmCham Shanghai applauds a recent WTO ruling to allow foreign financial institutions to participate in China's electronic payment services (EPS), including both debit and credit cards, which processes over US$1 trillion each year. Previously, Shanghai-based Union Pay (UP) was the only bank card association allowed to provide card payment settlement services in China. Opening up this market will provide choices to China's consumers and market opportunity to U.S. payment service providers.

Additional liberalization efforts include easing cross border capital flow, such as a pilot launched by SAFE (State Administration of Foreign Exchange) for cross border foreign currency pooling. This pilot allows companies to set up a cash pooling account in China to consolidate cash from both China and overseas entities, and RMB cross border lending initiatives supported by PBoC. Regulators also published new measures to relax FDI control and simplify supporting documents for cross border settlement. These changes will enable foreign companies to manage their investments into and out of China in a more efficient manner.

Capital Requirements

Chinese regulations regarding capital requirements for derivatives trading, bond underwriting and lending are at odds with global standards. Current regulations set a high minimum capital requirement for commercial banks to enter China and present a barrier that prohibits all but the largest U.S. banks from entering the market
After meeting China's requirements, most foreign banks remain at a competitive disadvantage compared to their Chinese counterparts. In assessing a foreign bank's investment capital, Chinese regulators do not recognize the financial support provided to China-based foreign banks from their banks' parent groups. Furthermore, U.S. banks cannot leverage their parent group's capital and liquidity strength and frequently struggle to bring their offshore technology and knowledge into China to support their China business.

For the complete "U.S. Competitiveness in China: Opportunities and Challenges in America's Fastest Growing Overseas Market" whitepaper by the American Chamber of Commerce Shanghai, please refer to our website http://www.pwccn.com/home/eng/fbic_2013.html

The European Chamber of Commerce White Paper - Banking and Securities Working Group

1. Regulatory Relationship and Coordination

1.1 Involve Foreign Banks in Regulatory Discussions and Policies (SCLAO, CBRC, CSRC, PBOC, SAFE)

- Engage foreign banks in the discussion of the macro prudential supervisory framework where RMB loan quota is a key regulatory measure of controlling RMB loan growth and various monetary policy measures (including additional Reserve Requirement Ratio) are available for use as a penalty against banks (including foreign banks) whose RMB loan growth is outside of the People's Bank of China's (PBOC) expectation.
- Encourage the differentiation of regulatory requirements for banks of different types and sizes to accommodate for discrepancies in business models and the relatively small size of foreign banks in China that need to fulfil the regulatory requirements of both home and host regulators.

1.2 Strengthen Coordination Amongst and Within Regulatory Authorities (SCLAO, CBRC, CSRC, PBOC, SAFE)

- Strengthen coordination and cooperation between different government institutions and regulators with responsibility for financial services both at home and abroad.
- Establish one regulator as the authorised government body to play a proactive role in coordinating with other regulators, to share survey results and make sure regulators are on the same page on various supervision tasks.
- Find effective ways to simplify reporting requirements without sacrificing the necessary supervision of information.

2. Ownership and Business Scope (SCLAO, CBRC, CSRC, PBOC, SAFE)

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

3. Licenses, Quotas and Ratios

3.1 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.

3.2 Improve the Speed and Transparency of the Licence Approval Process (CBRC, PBOC, SAFE, CSRC)

- Abolish the three-year waiting period to which foreign banks are subject before being eligible to submit an application for the RMB license.
- Speed up the RMB clearing membership licence approval as a part of the RMB licence.

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

- Grant foreign banks equal rights with local banks.
- Lower the access criteria for foreign banks, accelerate the approval of foreign banks and securities companies to underwrite the China Government Bonds (CGB), the PBOC bills, and financial and corporate bonds in the inter-market.
- Build the basic framework of a normal liquid government bond 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.

3.4 Remove Foreign Debt and Guarantee Quota (SAFE, NDRC, PBOC)

- Remove the short-term debt quota for genuine trade-related uses and remove the Foreign Guarantee Quota.
- Deepen onshore liquidity by putting in place market-based means of funding, with the PBOC acting as lender of last resort, using international rates as a benchmark.
- Introduce a system where foreign-invested companies can renew their own foreign debt quota, if they have consumed the quota in the past.

3.5 Review and Amend the Loan-to-Deposit Ratio Requirements (CBRC)

- Allow a five-year transition period to start from the date of incorporation for each bank rather before enforcement.
- Allow other stable liquidity sources to be accounted for in the calculation of this ratio (particularly Certificates of Deposit).

3.6 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 and thus ensure equal treatment for Chinese and foreign banks as agreed in the WTO.

3.7 Loan Loss Provisioning Ratio (CBRC, MOF)

- Increase communications between regulators and banks (including foreign banks) about the two ratio requirements and accounting treatment.
- Encourage regulatory incentives to banks (including foreign banks) with robust credit risk management and low non-performing loans (NPLs) by waiver of such ratio requirement to foster the development of strong, autonomous risk-management practices.

3.8 Address Funding Limitations in the China Foreign Exchange Trade System Interbank Market (PBOC)

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

3.9 Resolve Taxation Issues (SAT)

- Waive the 5.65 per cent Business Tax on onshore and offshore lending.
- Waive the 10 per cent Withholding Tax on offshore funding.
- Waive the 5.65 per cent Withholding Business Tax levied on service payments to overseas service providers.
- Abolish the cost-based income taxation of representative offices as it evidently creates a conflicting situation and cost burden not matched by any income generation, or allow representative offices greater freedom in terms of acquisition of business and customers on behalf of head office or other branches.

For the complete "Banking & Securities Position Paper 2013/2014" by the European Chamber of Commerce, please refer to our website http://www.pwccn.com/home/eng/fbic_2013.html

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- Indirect tax planning and compliance
- Aviation and ship leasing
- Cross-border lease structuring

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