The Liberalisation of Foreign Ownership in Chinese Financial Institutions: Speculating on the Motivations behind the Opening

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Abstract

Following the November 2017 announcement of the impending opening of Chinese financial institutions to majority foreign shareholding, the author speculates on the potential reasons motivating the liberalisation. By examining the current deficiencies of the Chinese financial sector and the ways other countries benefited from following a similar reform path in the past, three speculative justifications are proposed. The deficiencies are tested against the hypotheses derived from the literature on financial opening in those other states to evaluate how they could be assuaged by the latter. It is found that the opening could have been driven by a desire to introduce competition in a complacent banking environment, to create new lending sources for small and medium-sized enterprises, and to refocus market players around profit maximisation considerations rather than political ones.

Keywords: finance; liberalisation; banks; foreign ownership.

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Introduction

On 10 November 2017, then Chinese Vice Finance Minister Zhu Guangyao 朱光耀 announced his government's intention to introduce policy for the removal of foreign ownership limits in commercial banks, asset management firms, securities firms, insurance companies and fund management firms (Reuters staff 2017). Then, again, at the 2018 Boao Forum in April, the newly appointed People's Bank of China (PBoC) Governor, Yi Gang 易纲, reiterated this policy intention for reform and promised the first changes would take place by 30 June 2018 (Wang and Chen 2018). These announcements represent a radical directional shift by the Chinese government.

The current foreign involvement in the financial sector of the People's Republic of China (PRC) is minimal and heavily restricted. The central Chinese government imposes strict limitations on how foreign financial institutions can enter its market. As it stands, they are allowed to initiate greenfield investments by independently incorporating Chinese subsidiaries in order to compete with already-established Chinese firms. However, trying to cut out a market share from the Big Five state-owned banks (SOBs), i.e. the Agricultural Bank of China, the Bank of China, the Bank of Communications, the China Construction Bank, and the Industrial and Commercial Bank of China, is a near impossible task, as will be discussed in these pages. The preferred method of entry would thus be through brownfield investment, which means the acquisition of an established local bank. This is where the restrictions have been imposed until 2018. Securities firms, fund management companies, commercial banks and asset management companies all have a twenty percent cap on individual ownership in a Chinese counterpart and face a "twenty-five percent aggregate ownership limit for the total shareholding of all foreign investors" in said counterpart (Zhou 2017). Insurance companies are currently limited to fifty percent ownership in their Chinese equivalent (ibid.). Because of the unfavourable environment for foreign investors, only a handful of non-Chinese players have a sizeable presence in the PRC. HSBC is the only foreign-controlled bank and AIA is the sole non-Chinese insurer that managed to succeed substantially through greenfield investment (Panckhurst 2017). Several other institutions run large scale activities but are bound by the ownership restrictions. Examples are UBS, ING, and Schroder for mutual funds; and Manulife and Prudential for insurers (ibid.).

The autumn 2017 announcement's accompanying timeline outlining

the opening up process over the next five years states that for asset management companies and commercial banks, foreign investors will be treated the same as their Chinese counterparts, thus eliminating the ownership caps immediately (Zhou 2017). For securities firms and fund managers, that will happen three years later, but in the transition period they will be allowed to hold up to fifty-one percent of the stock of a Chinese firm (ibid.). For insurance companies, that fifty-one percent ceiling will be created three years from the present and ownership limits will disappear completely in five years (ibid.).

Research question

The question at the heart of this research is: what motives lie behind China's 2017 announcement of the liberalisation of foreign ownership of its financial institutions?

Since the government has not provided a clear justification for the reform, the conclusions of this research will have to be speculative. By first looking at how other countries have benefited from such financial reforms and then at the failings of the Chinese financial sector, one will be able to come up with theories that may help explain this liberalisation. Understanding what motives may be lying behind this recent step forward will help the reader gain foresight about China's future role in the global financial order.

The scope of this research is limited to financial and economic considerations. Thus, questions revolving around national sovereignty or Communist Party legitimacy as potential motivation for the reform are omitted. The author rather attempts to speculate about reasons behind the opening from a liberal perspective which posits that market efficiency is favourable.

Literature Review

This review of the literature on the merits of opening a country's economy to foreign-owned financial institutions identifies possible gains from market opening so as to draft a list of benefits that China might be pursuing in its reform process.

Initial seminal research

In 1998, the World Bank researched the effects of foreign banks' entry in domestic markets by looking at eighty countries and 7,900 banks over the period of 1988 to 1995. Its main finding was that foreign banks entering developing markets are more profitable than domestic banks (Claessens, Demirguc-Kunt, and Huizinga 1998: 13). The advantage they have was attributed to their technological and managerial superiority, which gives them the power to disrupt markets in which complacency and the lack of efficiency reign (ibid. 16–17). More efficiency powered by more competition has positive repercussions on the welfare of customers as a whole, who will profit from better returns on investment and cheaper loans (ibid. 19).

Reproduction and expansion

The above-mentioned study was replicated in 2001 with a focus on twenty-six developing countries over the period of 1990 to 1996. It found that the economy as a whole was indeed better off with foreign-owned banks (Hermes and Lensink 2001: 6). Increased competition pushes banks' profit margins down and foreign banks' superior banking practices are adopted by domestic firms (ibid. 7). Overall, the consumer is better off, regardless of the number of foreign banks in the market, but local banks' profitability does get eroded once their power to raise interest rates is affected (ibid. 8).

Being new entrants, foreign firms suffer from information asymmetry compared with domestic competitors in regard to client data. This naturally leads to risk aversion and concentration of activities on customers with larger collaterals and of whom reliability was proven in other markets, limiting the pool of clients to larger transnational companies (Sengupta 2007: 517). Nonetheless, it has been shown that, especially in developing markets, when banks enter through brownfield rather than greenfield investment, the information asymmetry can be overcome (Bruno and Hauswald 2014: 1684). When foreign banks acquire an established local player, they obtain their borrowers' information, which they can couple to their superior banking practices to offer the best products possible to higher-risk clients as well (ibid. 1708). This way, foreign banks can afford not asking for massive collaterals and therefore can start lending to Small and Medium-sized Enterprises (SMEs) in ways domestic counterparts could not do before.

Zeroing in on country-specific experiences, namely that of the Philippines, shows that such reform indeed markedly improves competition and efficiency (Unite and Sullivan 2001: 17). What distinguished the country from other developing markets is the small role that the government played in its banking sector, instead having a high concentration of bank ownership by family corporate groups (ibid. 10). Studies show that those family corporate groups' links with politicians were negatively affected by foreign entry, making the system more independent and less relationship-based, and thus less prone to corruption (ibid. 21). However, in countries with high state-ownership of banks, the "cartel-like environment could distort results" (ibid. 10). Thus, the erosion of relationship-based lending because of foreign bank entry cannot be expected in all markets.

Hypotheses

For the sake of this article, only three of the nine original identified impacts are covered as only they could be matched with the problems identified in the Chinese economy.
The entry of foreign financial institutions in a domestic market can:

Hypothesis 1: increase competition;
Hypothesis 2: increase lending opportunities to SMEs when foreign banks enter through brownfield investment;
Hypothesis 3: reduce relationship-based lending.

By looking at the deficiencies of financial institutions in China today in the following section, it is hoped that matches will be found between current failures and potential impacts of liberalisation as identified in this chapter.

Failures and limitations of Chinese financial institututions

To truly appreciate the level of economic liberalisation in today's PRC, one has to recognise how much progress has been achieved in the last forty years. The economic reforms initiated in the country since 1978 have diametrically changed it, taking the nation light-years away from where Mao Zedong 毛泽东 has left it upon his death in 1976. Under the leadership of Deng

Xiaoping 邓小平 and his successors, changes have gradually been introduced and have transformed the planned communist economy into one that can best be described as globally-integrated market socialism (Guo 2012: 252).

The agencies that regulate the financial institutions sector in the PRC today are the China Banking Insurance Regulatory Commission (CBIRC) and the China Securities Regulatory Commission (CSRC), both directly overseen by the State Council. Several other regulatory tasks are the responsibility of the PBoC such as "preventing and mitigating systemic financial risks" and "providing guidance to anti-money laundering work in the financial sector" (The People's Bank of China 2013).

Level of international exposure

China is far from being isolated when it comes to contributing to and abiding by global financial norms and best practices as it is bound to respect, among others, the World Trade Organization and Basel Committee on Banking Supervision rules since its 2001 entries in such bodies.

Even with the previously outlined stringent limitations on foreign involvement in financial institutions, total assets owned by foreign banks in the PRC have grown about twenty percent year on year since 2006, reaching CNY ¥2,680 billion in 2015 (KPMG 2017: 37). Nonetheless, because this rise mirrored the general boom in the industry during this period, in terms of proportion to the total assets of the Chinese banking sector, it dropped from 2.38% in 2007 to 1.38% in 2015 (ibid.). The involvement of non-Chinese actors in the field is therefore minimal.

Contrary to its globally-connected supply chain economy, China's financial sector remains shielded. While, in 2008 and 2009 its exports dropped because of sluggish global demand, its Big Five banks reported profits, in stark contrast with major defaulting American and European banks. With the allowance of foreign ownership of financial institutions will inevitably come a larger degree of exposure to international financial ebbs and flows.

Relative limitations of the sector

Identifying the failures and gaps of financial institutions is the critical second step in this speculative research.

Uncompetetiveness of players

Unsurprisingly, if the stock of all major players in the market is held by the same entity, i.e., the state, creating a truly competitive environment will be challenging. Several experts point towards this uncompetitiveness and resulting non-differentiation between financial institutions as a key problem of the Chinese system (Woo et al. 2014: 160; Stent 2017: 148). Economists have pointed to several solutions SOBs could introduce to differentiate themselves (Chen et al. 2018: 56). However, incentives to take these steps are quite weak since the established banks profit from the status quo. Macroeconomic decision-makers in Beijing are far from ignorant of this. Last year, previous PBoC Governor Zhou Xiaochuan 周小川 shared that there should be an injection of competition, stating that "[p]rotecting domestic firms from outside competition makes them lazy, which weakens them and may lead to financial instability" (Bloomberg News 2017). It would be hard to obtain competition without opening up the sector to private players, and as outlined by the ex-governor, this economic argument could also apply to foreign actors.

Limited loans to SMEs

Having been created initially as capital providers to SOEs, SOBs have not developed the habit or the expertise in SME lending. Chinese banks tend to perceive SOEs as safer clients because of the assumption that if they default on a loan, the central government will step in to save the banks from suffering catastrophic losses (Woo et al. 2014: 261). This difficulty to be lent to because of perceived risk pushes SMEs to seek alternative financing outside the regular system such as in trust funds or wealth management companies, where they cannot but pay higher interest rates (Stent 2017: 133). They therefore waste more resources on paying back loans than SOEs, although their productivity has been proven to be higher, which points towards a clear bias in the system (Woo et al. 2014: 261). Although SMEs represent about 99.6% of enterprises in the country and employ seventy-five percent of city-dwellers, they only obtain twelve percent of their financing from bank loans (Shen et al. 2009: 800). Recent policy guidelines and laws have attempted to rock this system and promote SME lending, but large banks have maintained their priority of financing SOEs, which some have criticised as being more politically-driven than economically sound (Wonglimpiyarat 2016, 54; Liu 2016, 246).

Non-profit maximisation priorities

In the Chinese financial system, politics sometimes trump economics as too little focus is given to profitability enhancement and too much to political considerations (Woo et al. 2014: 263; Stent 2017: 126). Bank Chief Executive Officers (CEOs) are officially mandated by the State Council to avoid risk, and thus forgo the development of SME lending, although opening this segment might reap great profits (Stent 2017: 120). Requirements such as these have a major influence on SOBs because the CBIRC controls all their supervisory boards, forcing the implementation of a policy. When political powers decide that SME lending should not be prioritised, SOBs have to follow suit and dedicate resources to SOEs. Financial institutions CEOs and upper management's promotions and career advancement is seen to "largely depend on how well they carry out the instructions of the central or local government, and less on the creation of bank value" (Chen et al. 2009, cited in Dong 2014: 122). The idea that political forces hinder profitability maximisation is supported by the fact that banks without state-ownership tend to be more efficient and profitable (Jiang, Feng, and Zhang 2012: 143). Other research has clearly shown that in the case of joint venture banks, "the proportion of politically-connected directors has a negative relationship with [return on assets]" (Liang, Xu, and Jiraporn 2013: 2962). Government's political goals are therefore forced onto SOBs through the appointment of their top decision-makers.

Several other deficiencies of Chinese financial institutions exist, but for the sake of this article, only problems yielding associations with hypotheses are covered. Overall, the main deficiencies of the current Chinese financial institutions appear to be:

Problem 1: Most large players are un-competitive;
Problem 2: A disproportionate share of loans are given to SOEs, disadvantaging SMEs;
Problem 3: The top management has other concerns than profitability enhancement.

Hypothesis-problem combinations speculation

Having established a list of three hypotheses and three problems, one can now turn to matching them in order to establish potential motives lying

behind China's 2017 announcement of liberalisation of foreign ownership of its financial institution industry.

The first association is of problem one with hypothesis one, that most large players are currently uncompetitive and that opening the market to foreign ownership could increase such competition. It has been shown that experts in the field and Chinese leaders agree there is laziness in the system stemming from weak competitive forces (Woo et al. 2014: 160; Stent 2017: 148; Bloomberg News 2017). Because of that, Beijing may want to replicate the experiences of several developing countries which have seen competition grow after foreign financial institutions entered their markets (Claessens, Demirguc-Kunt, and Huizinga 1998; Hermes and Lensink 2001). Increased competition for any product or service has the tendency to drive down prices as suppliers fight for consumers. Therefore, enhanced competition can be predicted to lower market prices for financial services, which would in turn leave consumers with more money in their pockets, boosting overall welfare.

The second association is between problem two and hypothesis two. Too little investment is funnelled towards SMEs, some of the most productive parts of the economy, because of risk-avoidance preferences, while, as pointed out in the literature review, it has been shown that when foreign banks enter through the acquisition of a domestic firm, they are better suited to offer products to higher-risk clients, and thus start lending to SMEs (Bruno and Hauswald 2014: 1708). Because the reform will allow exactly such bank acquisition to take place by raising foreign ownership caps above fifty percent, the problem of SME lending could therefore be partially tackled by having more financial institutions lending to SMEs. SOBs are neglecting this market segment, which leaves it wide open for foreign players to come and fill. Standard Chartered and the Bank of East Asia's Chinese branches have already proven extremely effective at SME lending, accounting for twenty percent of the latter's profits in the coming years (Pham 2018). One can only imagine the potential boom in this segment once foreign banks can acquire Chinese competitors in order to scale operations.

The last association is of the problem of Chinese banks' top management's political concerns impeding on profitability with the hypothesis of decreased relationship-based lending. SOE lending prioritisation is a political decision forced on banks' top management which hurts profit maximisation, but could be disrupted by the entry of sizeable foreign players without linkages to political players. The Philippine experience's family-corporate groups' links with politicians were, like in the Chinese case,

hurting profit maximisation (Unite and Sullivan 2001: 21). In both cases, the top management is driven by non-business incentives because of political affiliations, whether that is personal enrichment or bad investment decisions, which hurt the profitability of the banks. Foreign entry in the Philippines led to a great lessening of this problem, and it is believed that a similar result might be pursued by Chinese reformers.

Implications for China's future

Even if the speculations outlined in this research are proven correct, what they only reveal are the motivations behind the sector's opening. What it cannot tell us is whether the potential gains that are being pursued will materialise.

Yet, the government has gone ahead and started following its timeline. The category of financial institutions that has seen the most concrete advances is that of securities firms. The CSRC introduced measures raising ownership caps to 51% in April 2018 (China Securities Regulatory Commission 2018). An accompanying statement set the same heightened limits for fund managers (Deng 2018). This therefore opened the door to foreign players already present in China through joint-ventures to buy out their local partner and gain control. A week later, UBS, Nomura Holdings and JPMorgan Chase were filing applications to raise their respective joint-venture ownership in securities firms to 51% (China Banking News Editor 2018a). Finally, in December of the same year, UBS announced it had received the final approval to transition to majority ownership of its operations (China Banking News Editor 2018b). All that remains is for the bank to buy out other shareholders to gain control. The fact that the promised reform was seen through for securities firms shows genuine dedication on the part of Beijing to transform the sector.

Encouragingly, the CBIRC released in late October 2018 draft regulations to allow the establishment of majority-owned foreign-invested commercial banks (China Banking News Editor 2018c). Although the timeline stipulated this should have happened back in November 2017, the promise is nonetheless being kept. No information has been released as of now regarding what banks might have applied to raise their ownership share, but if the process mirrors that of securities firms, approvals should trickle in during the months to come as of writing this article.

The central government is therefore sticking to its word, although at a slower pace than what it had initially outlined in its timelines. At the moment, no draft rules or guidelines have been introduced for asset managers or insurance companies.

Conclusion

Drawing from other countries' experiences and current assessments of the Chinese financial sector, this article has speculated that three main motives lie behind the announced liberalisation. First, opening the market to foreign ownership could increase the competition, which is currently lacking. Second, SME lending could greatly increase because of foreign banks' lack of aversion towards doing so, contrary to SOBs. Third, introducing players which lack the political concern of Chinese banks' top management could reduce relationship-based lending and make financial institutions more efficient. All three goals could be attained thanks to foreign ownership.

Limitations of the research

As has been noted throughout this research, the inferences are purely speculative and therefore cannot with certainty point to motivators for the opening. Moreover, very little information on non-bank financial institutions is available. Thus, the conclusions may not be as accurate for asset managers, fund managers, insurance companies and securities firms. Furthermore, the research drew solely from English-language sources, although as many sources from Chinese academics were included as possible. Finally, lack of time and available sources made research into the question of sectoral specificity of the liberalisation impossible.

Avenues for further research

It would be interesting to closely track the promised reforms to make sure they are seen through or understand why they are not. Results from the liberalisation should then be researched to see if foreign players do indeed decide to enter and whether the potential benefits impact China. One could also research whether this is the first step in a slew of opening of other industries to foreign ownership or whether the financial industry is an isolated case.

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