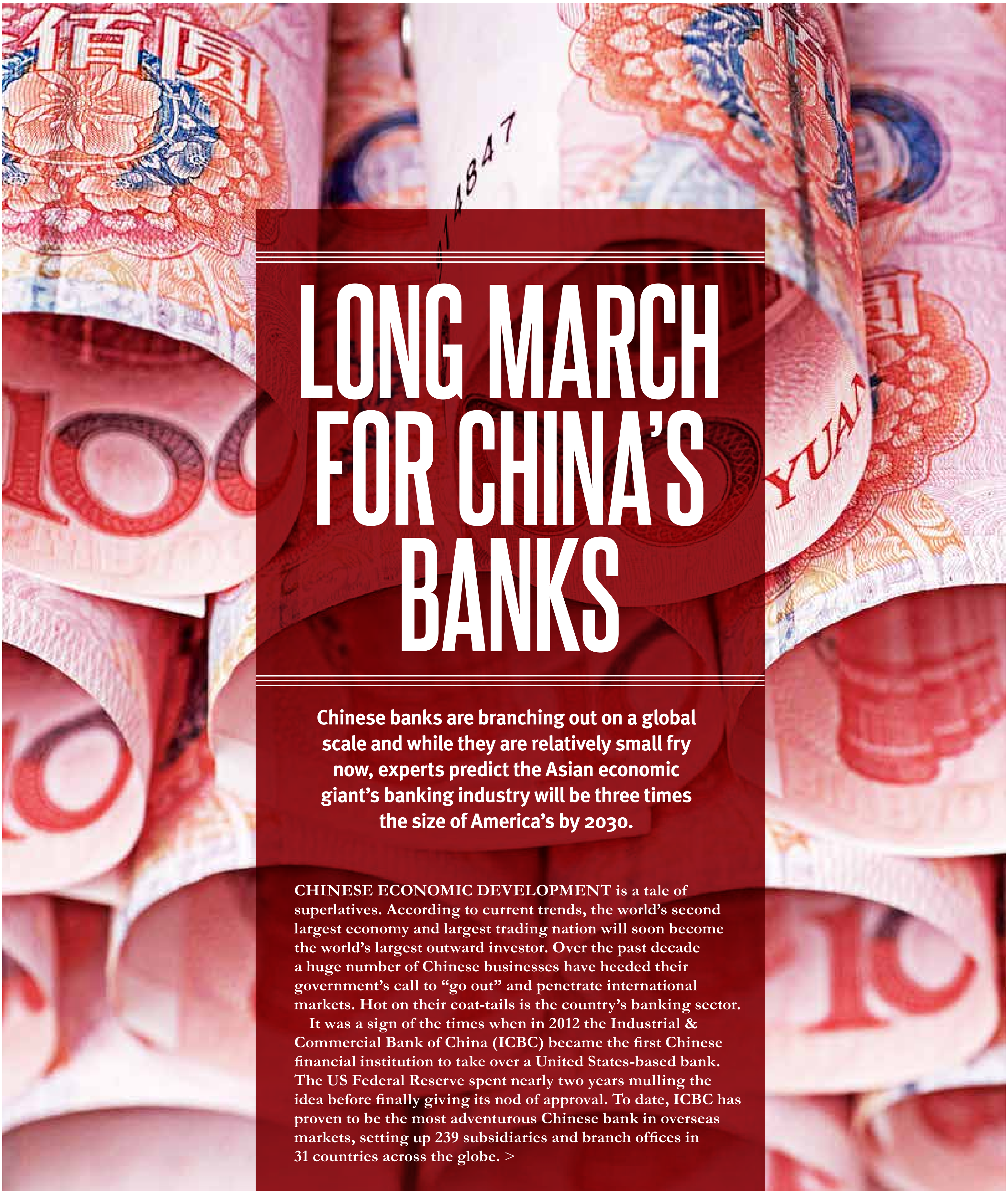
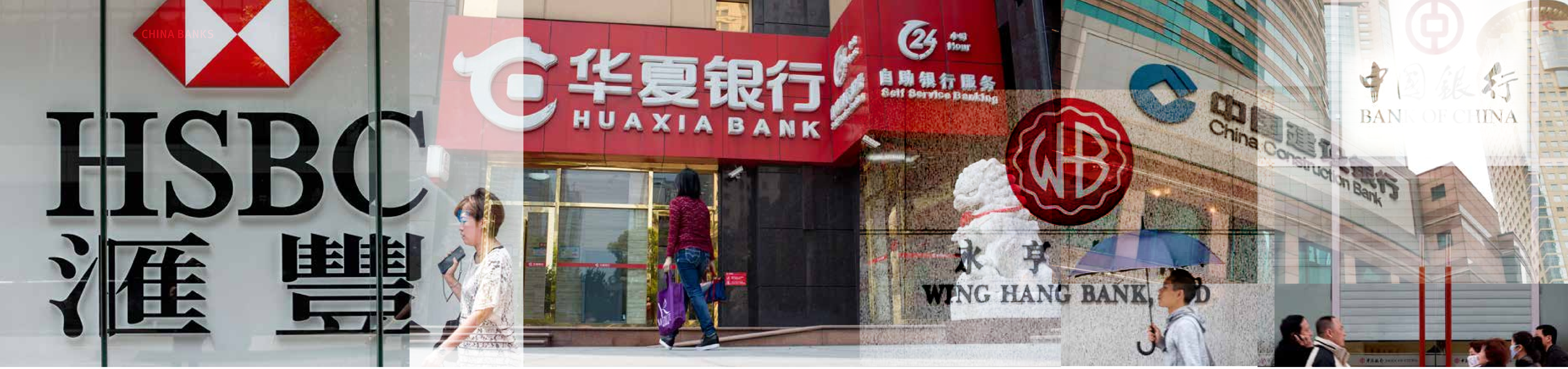


LONG MARCH FOR CHINA'S BANKS

Chinese banks are branching out on a global scale and while they are relatively small fry now, experts predict the Asian economic giant's banking industry will be three times the size of America's by 2030.

CHINESE ECONOMIC DEVELOPMENT is a tale of superlatives. According to current trends, the world's second largest economy and largest trading nation will soon become the world's largest outward investor. Over the past decade a huge number of Chinese businesses have heeded their government's call to "go out" and penetrate international markets. Hot on their coat-tails is the country's banking sector.

It was a sign of the times when in 2012 the Industrial & Commercial Bank of China (ICBC) became the first Chinese financial institution to take over a United States-based bank. The US Federal Reserve spent nearly two years mulling the idea before finally giving its nod of approval. To date, ICBC has proven to be the most adventurous Chinese bank in overseas markets, setting up 239 subsidiaries and branch offices in 31 countries across the globe. >



Overseas operations are generating a growing percentage of Chinese bank profits. According to professional services firm Deloitte, ICBC's international operations accounted for 4.3 per cent of the bank's total operating income in 2012, with profits up 21.8 per cent year-on-year. Overseas assets were valued at US$162.7 billion, or nearly 6 per cent of the group's total assets.

ICBC is not the only Chinese bank expanding abroad. The Agricultural Bank of China (known as AgBank) has opened branches in New York, Hong Kong, Seoul and Singapore. And by the end of 2010, the Bank of China (BOC) had overseas assets valued at more than US$350 billion. BOC, China's fourth largest lender, saw its profits rise 14 per cent in the first three months of the year to US$7.3 billion, boosted by overseas lending.

By some measures the Chinese banking system is already the largest in the world. Four out of the world's 10 largest banks by market capitalisation are Chinese, and the next stage of China's financial development will be characterised by rapidly growing bank balance sheets. Experts predict that the Chinese banking industry will be almost three times the size of that in the United States by 2030.

But despite impressive domestic growth, there is a long way to go before Chinese banks can be considered truly international. With overseas operations still extremely limited compared to their multinational competitors, they are now driven by a desire to catch up and diversify business.

The opportunities open to China's banks overseas are twofold: first, the provision of capital across the globe, especially in areas where other banks have lost ground as a result of the global financial crisis. And second, the increasing internationalisation of the renminbi (RMB), for which there is now a growing appetite, both as a trade and reserve currency.

THE INDUSTRIAL & COMMERCIAL BANK OF CHINA (ICBC)

239 branches in 31 countries

International operations accounting for 4.3% of the bank's total operating income in 2012.

Overseas assets were valued at US$162.7 billion, that's close to 6% of the group's total assets.

SOURCE: DELOITTE

THE AGRICULTURAL BANK OF CHINA (AGBANK)

Recently opened branches in New York, Hong Kong, Seoul and Singapore.

Overseas assets valued at more than US$350 billion in 2010.

SOURCE: DELOITTE

Chinese banking growth overseas is likely to take place where Chinese firms have established significant trading relationships, and where offshore renminbi markets have taken hold.

"The key geographical markets are a consequence of these two types of opportunity," says Krishnan Narayanan, senior executive adviser for Greater China at Strategy& (formerly known as Booz & Company). "In terms of capital provision I would expect this to lead to more Chinese banking in South America, Africa and the Middle East in the short term. In terms of RMB internationalisation, this means activity in more developed markets such as London, New York, Hong Kong and Singapore."

The UK's chancellor of the exchequer, George Osborne, recently announced the appointment of China Construction Bank (CCB) in London as the first clearing house outside Asia for China's renminbi. He also said Chinese banks would be allowed to register as branches with the British financial regulator, meaning they would not need to hold as much capital within the UK to operate. This will put them on equal footing with banks from other major economies, such as US banks Goldman Sachs and Morgan Stanley, though on a significantly smaller scale.

Britain's move signals an attempt to ensure Chinese banks use London as their main operating hub in Europe. Last year, the Bank of England became the first of Europe's central banks to establish a currency-swap facility with the People's Bank of China (PBoC), supporting renminbi traders by providing funding when needed. Germany's Bundesbank has also agreed to work with PBoC on clearing renminbi payments.

Mirroring the UK, the Australian Securities Exchange (ASX) and BOC agreed in February this year to deliver renminbi settlement services to the Australian and Chinese financial markets, a move strongly supported by the Australian Government [see "Beijing Challenge" on page 68]. The move comes a year after the renminbi overtook the euro to become the second most-used currency in world trade finance.

In Latin America, China's banks are already well established as major loan providers and the loans are larger and growing faster than those provided by Western banks. Since 2005, Chinese banks have provided loans of around US$75 billion. In 2010, loans of US$37 billion totalled more than the combined sum loaned by the World Bank, Inter-American Development Bank and the Export-Import Bank of the United States.

A 2012 study by Kevin Gallagher, a senior researcher at Tufts University Global Development and Environment Institute (GDAE), and his colleagues found that China Development Bank loans carried more stringent terms than World Bank loans and that Chinese banks provide finance to a significantly different set of countries than international financial institutions and Western banks. These were countries such as Argentina, Ecuador and Venezuela, which are not able to borrow as easily in global capital markets. Chinese banks are largely focused on loans to natural resource-based and infrastructure sectors.

Chinese banks have also established a presence within their own region, particularly Singapore and obviously Hong Kong. Bank of China opened its first branch in Singapore in 1936, and services now include international trade settlement. ICBC established an outlet in Singapore in 1993 while AgBank opened in 1995, the branches marking the first overseas ventures for both banks.

Until now, Chinese banks operating overseas have largely focused their efforts on catering to Chinese businesses, especially in underdeveloped markets. These businesses, particularly those engaged in the hydrocarbon, resource extraction and construction industries, often require massive sums of money to finance daily operations.

Regardless of industry, international expansion by Chinese companies can be fraught with difficulty. Globalisation, especially for state-owned companies, frequently means confronting cultural issues and operating from a position of inexperience.

For the international arms of Chinese banks the situation is no different. Overseas branches often lag behind the operational and managerial capacities of more established multinational banks, with staff lacking the prerequisite language skills and knowledge of local culture and regulations to effectively compete for local clients.

But this situation is now gradually changing. Some Chinese banks have recently stepped up efforts to acquire or upgrade banking business licences and expand their retail banking network, enhancing their ability to serve domestic customers within those markets. Many top Chinese banks now routinely send their "fast-track" staff – even relative youngsters – abroad to acquire experience.

"Overseas business for Chinese banks is evolving from serving Chinese clients to building a strong local market presence with a strong volume of local clients."

NICHOLAS BORST, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

"Overseas business for Chinese banks is gradually evolving from serving Chinese clients to building a strong local market presence with a strong volume of local clients," says Nicholas Borst, China program manager with the Peterson Institute for International Economics.

"Chinese regulators have actually done quite a bit to promote the development of the asset management industry," continues Borst. "Chinese banks have been allowed to start fund management companies and offer wealth management products to their customers. I expect these services, as well as investment banking, to grow rapidly over the next several years."

"The issue is brand first and then capability development," adds Narayanan. "It's difficult to see how a bank like ICBC would attract top-notch asset management and investment banking talent in London or New York right now.

"The expansion of operations through commercial banking – to Chinese, but especially foreign companies overseas – will help, however. Once the brand is in place, capability in local and foreign financial centres will need to be built with care and skill. It won't be easy, but it's difficult to imagine that large Chinese banks won't try over the next decade."

The overseas expansion of Chinese banks inevitably means that China accrues more financial clout on the global stage. As more countries begin using the renminbi to settle international payments, the currency's role >

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KRISHNAN NARAYANAN, STRATEGY&

Beijing challenge

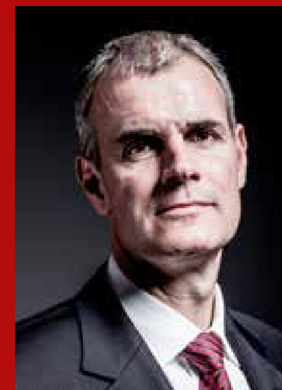
In Australia, major domestic banks are facing growing international competition for corporate clients from Chinese banks. The trend is expected to put pressure on the domestic banks' net interest margins, as they seek to compensate for a loss of market share in institutional lending by competing harder in other segments.

Brett Le Mesurier, banking analyst at BBY in Sydney, says the move of Chinese banks into the Australian market has been more noticeable in the past year. "While they are not here anything like to the extent of the major banks, the fact that they are providing credit is pushing margins down on institutional loans," he says.

"They find infrastructure particularly attractive and so that pushes the returns down for the major banks. The real impact that they are having is on the asset side of the banks' balance sheets."

The Australian Government was a very public supporter when the Australian Securities Exchange (ASX) and Bank of China announced in February that by mid-year they would bring renminbi settlement services to the Chinese and Australian financial markets. The new deal allows Australian companies to more efficiently process payments with Chinese investment and trading partners through ASX's Austraclear market infrastructure. RMB clearing services will expedite cross-border trade between China and Australia, and also lower operating costs and exchange-related risks. The trade relationship between Australia and China was worth A$120 billion last financial year. Australia now joins Japan and the US as the only countries to allow full convertibility of the RMB.

Elmer Funke Kupper, head of the ASX, says the deal provides a platform for the development of bigger and more diverse products and services in the RMB. When the deal was announced, Australia's then assistant treasurer, Arthur Sinodinos, said the move paved the way for Australia to export more financial services into Asia.



"[This] is a great opportunity to diversify our economy, and therein lies the opportunity for both countries working together. We welcome the opportunities that the greater internationalisation of the renminbi will provide for us in terms of trade and investment opportunities. We want more Chinese investment in Australia."

ELMER FUNKE KUPPER, ASX

in offshore markets will create additional leverage for the Chinese government in discussions with organisations such as the International Monetary Fund (IMF) and World Trade Organisation.

A few years ago, the former Chinese president, Hu Jintao, described the US dollar-led currency system as "a product of the past". However, with most global trade still taking place in US dollars, the Chinese are pushing hard for change. Never in world history has one government had so much control over so much wealth, and it comes as little surprise that Beijing is deploying its vast economic wealth to advance foreign policy goals. Today, increasing the volume of renminbi cross-border payments is a key tenet of central government policy.

"The Chinese government has laid out a clear agenda for the internationalisation of the RMB," says Sarah Butler, managing director for Greater China at Strategy&. "This will move forward in a controlled, measured way, building on early experiments and gradual economic opening up."

Five years ago the People's Bank of China began loosening currency controls, allowing companies on the Chinese mainland to use RMB from cross-border transactions. According to Deloitte, two years later cross-border renminbi transactions were recorded in more than 180 countries, with the total value of settlements exceeding US$400 billion.

With the ongoing internationalisation of the renminbi, there has been a new choice for Chinese companies and banks to freely choose their settlement and investment currency, making it easier for them to lower the cost of financing and conversion by raising funds from different onshore and offshore renminbi markets.

Over the next decade, the importance of the renminbi as an international currency will continue to rise, primarily through trade settlement. However, the growth rate of offshore RMB markets may decrease, because much of the growth to date has been driven by expectations of one-way currency appreciation.

"The recent round of renminbi depreciation has called into question the long-term trend of appreciation," says Borst. "Going forward, investors may be less willing to hold the currency. The RMB will certainly not replace the [US] dollar anytime soon, as China's restrictions on capital inflows and outflows will prevent it from being a dominant international currency."

"It is hard to see the RMB challenging the dollar over the next 10 years," agrees Butler. "Beyond then, looking out 20 to 30 years, clearly the financial 'centre of gravity' will continue shifting east, with China being the key player. It will still take a lot to shift the dollar from being the global reserve currency."

"By 2020 the RMB should enjoy a far stronger position in terms of its volume and global acceptance," says Eric Yang, director of SWIFT Asia Pacific's China Domestic Markets & Initiatives. "The bold judgement is that the RMB will eventually achieve full convertibility. It will rank highly as an international currency, but below the dollar in importance, and probably the euro."

With Western banks still struggling to manage risk and rebuild portfolios after the 2008 and eurozone crises, Chinese banks are likely to face little competition as they explore underdeveloped markets. To maintain and fully monetise their expansion, however, they will need to understand and adapt to the needs of local clients as well as Chinese ones. This means improving human resource capabilities as well as offering more sophisticated financial products. ■