Shanghai Flash

ISSUE NO.1 ❖ February 2007

Shanghai's Move towards a Competitive Financial Centre in the WTO post-accession Era

This report is the first issue regarding the development of Shanghai's financial sector. The reports will be conducted on an irregular basis, depending on the process of development.

A decade after a financial crisis swept Southeast Asia and five years into its WTO membership, China has accumulated broad experience on financial reforms and is trying to create an open and efficient modern national financial system. In the meantime, lured by the RMB retail business opened to foreign lenders upon WTO commitment, overseas banks are working to boost their participation. As the historical financial hub of China and Far East, Shanghai is exerting itself to regain its strategic position in the new arena of China's WTO post-accession financial field.

Shanghai – on its move to a national and regional financial centre

Since the 1850s, a number of foreign countries already opened a total of 68 banks in Shanghai. Later on, local banks with bureaucrat-capitalist (mainly from Beijing) and national-capitalist origins were also established. Most of these had their main offices here. Shanghai became the chief financial, commercial and shipping centre of China and ranked among the top ten commercial ports in the world.

After the establishment of the People's Republic of China in 1949, Hong Kong benefited from the emigration of thousands of Shanghai business people and arose as the Asian financial centre. Under the planned economy, China's finance was centralized in Beijing, for the reason that the banks' role was to reallocate capitals in providing loans to SOEs to keep the employment. The opening up of Pudong in 1989 favoured Shanghai with unprecedented opportunity to re-build its position. A new fiscal contracting system redefined Shanghai's relationship to the central government and allowed the city to keep a larger share of its revenue. The Pudong New Area and Lujiazui Financial and Trade Zone were specifically designed for the city to resume its former role. After series reforms, it has emerged as the centre of bond trading and a favourite headquarter for Chinese and foreign companies.

As a strong sign of the central government's determination to turn Shanghai into a financial centre, the 2nd headquarter of People's Bank of China was opened in August 2005 in Shanghai, moving the market-related functions of the central bank to Shanghai, while Beijing focusing on macro-control functions. Under the central bank's guideline, the watchdogs, CBRC, CIRC and CBRC at municipal level, supervise the operations of different financial entities. Furthermore, the Financial Service Office of the Municipal Government aims at providing better environment for the financial sector growth.

The Shanghai government is exerting itself to build Shanghai, especially Pudong area, into the financial centre in the WTO post-accession era. The total added value of financial sector in Pudong reached RMB 31.4 bn (USD 4 bn), accounting for 13.3% of the Pudong's GDP in 2006, and it is expected to increase to 20% in 10 years' time. In an effort to provide better environment for foreign financial institutions, mainly three measures are conducted:

- The current 1.7 km² Lujiazui Financial Zone in Pudong New Area will be expanded eastward to add to the zone another 0.7 km²
- Policies will be tailored to new comers, which will include preferential treatments such as office lease subsidies, tax refund, and executive training programs
- Assistance will be provided to improve expatriates' living condition in the respects of housing, children's education and spouses' job seeking

The first 9 incorporate foreign banks all registered themselves in Shanghai. By the end of last November, the deposit volume of foreign financial institutions in Shanghai already accounted for 13.6% of the city's total deposits. On its move to a national and regional financial centre, Shanghai now accommodates total 3,100 banking institutions, including 36 incorporate foreign banks and their institutions, 27 operation centres, 5 national credit card centres, and 100 representative offices of foreign banks. By the end of 2006, the total assets of foreign banks in Shanghai has amounted to USD 65.2 bn, accounting for 56% of China's total.

But Shanghai is not alone on its move. The most prominent rivalry is still from the historical old one - Hong Kong. With its accumulated extensive financial expertise and strong corporate governance, widespread knowledge of English and close ties to global markets, Hong Kong overshadowed Shanghai in many ways. Although Shanghai stock exchange has skyrocketed in 2006, Hong Kong's stock exchange had the highest volume of IPO, more than four times the amount of market Shanghai (Table 1).

Table 1: 2006 IPO volume in billion of USD

No.1	Hong Kong	41.22
No.2	London	39.31
No.3	New York	29.22
No.4	Nasdaq	17.47
No.5	Euronext Amsterdam	12.52
No.6	London AIM	11.92
No.7	Moscow	11.76
No.8	Frankfurt	9.74
No.9	Shanghai	9.62
No.10	Tokyo First Section	8.99

Source: Thomson Financial

Hong Kong's IPO volume is largely due to the listing of several Chinese banks and other big institutions, among which, some are considering coming back to mainland market. The independent monetary system also restricts Hong Kong's ambition to be the nation's financial capital.

Shenzhen, where China's second Stock Exchange is located besides Shanghai, lost its advantage of proximity to Hong Kong after Hong Kong was taken back to China in 1997. It was never really able to come into arena of competing major financial markets like Shanghai. Table 2 shows the comparison of the two stock exchanges:

Table 2: Shanghai & Shenzhen Stock Exchange

	Founding Date	Total market capitalization	Listings	Equities	Percentage of GDP
Shanghai	26.11.1990	7,161.2 bn	842	886	39.3
Shenzhen	01.12.1990	1,779.2 bn	579	621	9.76

Source: Shanghai & Shenzhen Stock Exchange

Shanghai is not only competing with Hong Kong for China's financial top spot. Tianjin was recently selected by the central government for an experiment with limited convertibility of the RMB. China's first over-the-counter equity bourse is also likely to be set up in Tianjin. Hong Kong was also authorised to begin trading bonds denominated in RMB. Those are part of moves by the central government to build a multi-layer capital sector with new financial hubs for political balance.

Looking across the border, Tokyo and Singapore are strong rivals for playing the role of leading financial centre in Asia,. Tokyo still has Asia's largest stock and bond markets and Singapore is the main centre for trading oil and other energy products, and is an important hub for currency trading.

Nevertheless, Shanghai was the world top performer with its stock exchange last year and is sharpening its competitive edge to the aspiration of becoming "the New York of the East".

Fundamentally Shanghai's move is taking place within the positive trend set up by the broader reforms in financial sector carried on by the central government after China's accession to the WTO.

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China's Reforms in financial sector

Since economic reform in 1978, the government have been gradually transforming China's financial system. People's Bank of China has been established as the central bank. The "big four" state-owned commercial banks[1] have changed their roles and function while three of them have already gone public. The three policy banks[2], which are state-owned lenders that concentrate on meeting the country's economic goals instead of looking on their own profitability, will be commercialized, starting with the China Development Bank.

To develop China's equity market, two stock exchange markets have been created in Shanghai and Shenzhen. Gradually watchdogs have also been established to oversee the different components of the financial system[3]. Internationally, China has received observer status in the FATF (The Financial Action Task Force) and is quickening its steps on anti-money laundering legislation.

Taking into consideration that none of the financial components were not even existent before the reform, the progress have been remarkable. The effectiveness of China's financial components improved rapidly. According to CBRC, China's domestic commercial banks cut the ratio of non-performing loans to 7.51% in 2006 from the double-digit level (31% in 2001) several years ago. However, with many components just growing from their infancy, China's financial sector still has some characteristics for historic reasons:

[1] China Construction Bank (CCB), Bank of China (BOC), the Industrial and Commercial Bank of China's (ICBC) and Agricultural Bank of China (ABOC)
[2] The China Development Bank, the China Export and Import Bank, the Agricultural Development Bank of China
[3] China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (SIRC)

- China's financial system is dominated by a rather weak banking sector which lack experience in credit assessment, risk management. Although the officially reported non-performing loans (NPL) fell considerably, almost 60% of the decline was made by transferring of bad loans from banks into state-owned asset-management companies.
- Underdeveloped equity market with two-third government owned non-tradable shares as well as insiders and speculative trading. But the share of equity market capitalization to GDP grew fast with the bullish market run in 2006, from 17% one year ago to nearly 50%.
- Corporate bonds issued by non-financial companies amount to just 1% of GDP, compared with an average of 50% in other emerging markets
- High saving rate. Chinese households save roughly 24% of their disposable income and 86% of the Chinese household assets are in bank deposits, accounting for almost 50% of the GDP and half of the banks deposits
- Closed capital account, which was recently partially opened to foreign direct investment and portfolio investments

To sustain the growth of the economy, further reforms of the financial sector has topped the government's agenda. Further reforms, such as floating of the currency exchange rate, partial interest rate liberalization, and the issue of corporate bankruptcy law are on the way. Moreover, following the lift of restrictions to foreign banks on 11th December 2006, Chinese players will be soon compelled with competition from foreign firms, who are specially interested in the WTO post-accession Chinese financial market.

China's WTO post-accession banking industry

Five years after China's WTO accession, the China Banking Regulatory Commission (CBRC) issued China's new Foreign-invested Bank Administrative Rules, opening domestic RMB retail banking services to foreign financial institutions. However, that doesn't mean full opening of China's financial sector and foreign lenders are still facing hurdles in their expansion in this vase potential market (Appendix 1).

Despite of these obstacles, big players have already taken their steps with advantages of attraction to high-end customers and talents as well as accumulated expertise and products with high added value. The first groups of 9 foreign lenders[4] were approved by CBRC to incorporate locally. Those 9 banks account for 34% of all foreign bank branches and owns 55% of the total foreign bank assets and 58% of their total profits in China. They are expanding aggressively to tackle RMB retail business. HSBC is already running some 25 branches and is opening another10 branches. The Hong Kong-based Hang Seng Bank plans to extend its operation on the mainland to more than 2,000 staffing working among a network of 50 outlets by 2010. Currently no Swiss banks are applying for a RMB retail licence in China. The branches of the two major banks of Switzerland, UBS and Credit Suisse, are focusing their scope of business on other domains.

In the meantime, Chinese banks are seeking foreign investment and technical help to enhance management, innovation ability and service quality. In 2005, foreign banks invested USD 18 bn in strategy stakes in several of China's biggest banks. But Chinese rules limit the stake that can be held in a domestic bank by a single foreign investor to 20% and caps 25% as the limit for total foreign investment in a Chinese bank, which means banking system will be still dominated by Chinese.

China's Equity market

[4] Standard Chartered Bank, Bank of East Asia, HSBC, Hang Seng Bank, Mizuho Corporate Bank
The Bank of Tokyo-Mitsubishi UFJ Ltd., DBS Bank, Citibank, ABN AMRO

In 1990, two stock exchange markets were experimentally established in Shanghai and Shenzhen. Together with Hong Kong Exchange, there are 4 classes of shares in China's equity market:

A-shares: denominated in RMB and available to domestic investors and QFII[5] (Qualified Foreign Institutional Investors)
B-shares: traded in USD or Hong Kong Dollars, were available originally to foreign investors only, now also to domestic investors
H-shares: listed in Hong Kong and only available to foreign investors
Legal person shares: non-tradable, held by founding shareholders, mainly government entities

Chinese stock market has historically been stagnant for mainly the following reasons:

- Government non-tradable shares (state-owned companies went public with one third of their equity in order to keep the ownership) and influences over IPO
- weak oversight
- many well-performed accompanies are listed on overseas exchanges
- insider trading scandals and lack of corporate governance

But last year, in response to the shareholding reform in order to eliminate the non-tradable shares as well as the improved corporate performance, the markets have gone from a five-year low since 2001 and virtually doubled with 131% increase in A-shares and 110% increase in B-shares. Apart from the re-gain of domestic investors in the markets, the combined scale of funds managed by QFII had reached USD 3.77 bn by the end of 2006, compared to USD 2.4 bn on Sep. 30, 2006. Their value grew 57% in the last quarter of 2006 on the back of China's rising stock market.

The CSRC is encouraging foreign pension and insurance funds to trade in RMB-backed securities in an effort to attract long-term investors to sustain market growth. The government eased rules of QFII project last August, allowing a broader class of investors and slashing capital requirements for market entry. The CSRC also cut the period under which foreign investors can't transfer their capital back home from a year to three months for pension funds, insurers and long-term mutual funds. However, China's market is still too volatile and less predictable for those risk-averse institutions.

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Useful sources of information:

The People's Bank of China: www.pbc.gov.cn
China Banking Regulatory Commission (CBRC): www.cbrc.gov.cn
China Securities Regulatory Commission (CSRC): www.csrc.gov.cn
China Insurance Regulatory Commission (SIRC): www.circ.gov.cn
Shanghai Stock Exchange: www.sse.com.cn
Shenzhen Stock Exchange: www.szse.cn

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[5] QFII (Qualified Foreign Institutional Investor): a license-and-quota system set up in 2003 to allow foreign companies to trade in RMB-backed securities, as part of the government's efforts to shore up the market maturity with foreign expertise. The CSRC together with SAFE issued QFII licenses to over 40 foreign institutions and the total quota has been expanded from USD 6 bn to USD 10 bn, among which UBS gets the largest share of USD 800 million, followed by Citigroup and Credit Suisse First Boston with USD 550 million and USD 500 million respectively

Appendix I

The main changes in the new Foreign-invested Bank Administrative Rules:

- Locally incorporated foreign-invested banks are entitled to engaged in all the RMB banking services local banks are allowed to do
- Branches of foreign banks that are not incorporated locally are only allowed to take local customers with a minimum deposit of RMB 1 million
- The customer and geographic restrictions on foreign banks doing RMB business are removed. Foreign banks are now allowed to offer RMB services and bank card services to Chinese individuals throughout the country without having to obtain the approval of the regulatory authority

Remaining obstacles for foreign-invested banks:

- Scarcity of outlets surely limits their access to vast customers. Furthermore, foreign banks will not be able to open more than one branch per year, which means they will not be able to achieve successful expansion in short period of time
- Excessive capital requirements (RMB 400 million equiv. EUR 39.6 million, compared with EUR 5 million registered capital a Chinese bank must prove to open a branch in the EU)
- Lending limits: Overall lending is not permitted to exceed 75% of deposits
- Administrative regulations and long waiting period for licences