Open for business: The incredible expansion of Chinese banks

In 2013, a Chinese bank came top in The Banker’s Top 1000 World Banks ranking for the first time. The Industrial and Commercial Bank of China (ICBC), one of China’s 'Big Four' state-owned commercial banks, has moved from third to first place on the back of a 15% increase in capital, surpassing JP Morgan Chase & Co and Bank of America.

ICBC’s seemingly rapid ascension is not isolated, in 2012 the Chairman of the second largest Chinese bank, “China Construction Bank” (CCB) Wang Hongzhang announced they had 100 billion Renminbi (US$ 16 billion) in cash to make an acquisition or at least take a stake of around 30-50% in a leading European institution with targets in United Kingdom, Germany and France. In fact, the so called Chinese “Big 4” banks are all ranked in the top 10 largest by asset value (see Table 1) and looking to expand. This success didn’t happen overnight but is the result of an aggressive strategy of overseas expansion that started more than 10 years ago. Chinese banks completed a total of 38 overseas M&A deals between 2002 and 2011. By the end of 2010, the oversea assets of Chinese-funded banks had exceeded US$270 billion and the China Banking Regulation Commission reported that 16 Chinese banks now own more than 1,000 Overseas companies in 40 countries.

Now, Chinese banking leaders have clearly laid their strategy on the table: Their plan is to build a worldwide group by acquiring institutions with an existing international presence, rather than focusing on their domestic market. And they have the financial muscle to achieve it; the four largest Chinese banks (ICBC, CCB, ABC and BoC) have all achieved double-digit growth in profits: ICBC announced that their 2012 net profit rose 15% to 239 billion RMB (US $38 billion), CCB profits were up 14% to 193 billion RMB (US$31 billion) compared to growth of 19% to 145 billion RMB (US$23 billion) for Agricultural Bank of China. By comparison, Bank of America announced a net income of US$19 billion and JPMorgan US$21 billion in the same period.

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1. Major Chinese banks are Industrial & Commercial Bank of China, China Construction Bank (CCB), Bank of China (BoC), Agricultural Bank of China (ABC)
2. According to a study published by HSBC, 4 in 5 international Chinese corporates plan to expand further overseas.
Table 1. Chinese Big 4 Banks are among top 10 Global Banks – Year 2013

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>World Rank By Asset values</th>
<th>Tier 1 Capital $M</th>
<th>Presence abroad in a nutshell (as of end of 2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial &amp; Commercial Bank of China</td>
<td>1</td>
<td>660,646</td>
<td>ICBC has nearly 400 overseas branches in 39 countries/territories</td>
</tr>
<tr>
<td>China Construction Bank Corporation</td>
<td>5</td>
<td>137,600</td>
<td>CCB maintains 76 overseas branches (including figures of HK and Taiwan) with presence only in Germany, Luxembourg, Vietnam, South Africa, Australia, the U.S., South Korea, Singapore and Japan</td>
</tr>
<tr>
<td>Bank of China</td>
<td>9</td>
<td>121,504</td>
<td>Bank of China has over 100 branches globally in 36 countries (plus another 500 or so in Hong Kong and Taiwan)</td>
</tr>
<tr>
<td>Agricultural Bank of China</td>
<td>10</td>
<td>111,493</td>
<td>ABC has branches in Hong Kong, London, Tokyo, New York, Frankfurt, Sydney, Seoul, and Singapore</td>
</tr>
</tbody>
</table>

Source – Official company websites

Despite this phenomenal growth, the appetite of the Chinese banking juggernauts for overseas acquisitions has now become a strategic imperative, not only to acquire the necessary know-how, but also to find new sources of growth. In 2012 financial analysts reported that Chinese banks’ profit growth appeared to be running out of steam, a year in which saw the lowest growth since 2006. This demonstrates the impact of a sharp deterioration in their domestic business as the demand for new loans fell and the number of credit defaults increased.

The figures speak for themselves: Chinese banks issued 2.3 trillion RMB (US$379 billion) of new loans in the second quarter of 2013, down 3 percent from a year earlier. In 2012, the China Banking Regulatory Commission announced there had been an increase in the number of bad loans for all types of institutions and the CCB set aside 16.1 billion RMB (US$2.64 billion) for bad loans in the first half of 2013, compared to 14.7 billion RMB (US$2.42 billion) a year earlier.

**Chinese Banks expansion to help Chinese Businesses expand overseas**

The expansion of ICBC- the bank considered as not only the most important global bank but also the most outward-looking bank in the past few years – is testament to how the Chinese government’s “Going Global” policy is working.

Although the first known Chinese overseas investment dates back to the previous century, the government formally implemented the “Going Global” strategy in 2000: All China’s “Big Four” state-owned banks are being encouraged by the government to expand their overseas financial profiles in order to provide financial services to major Chinese business interests operating in foreign markets.

The significant growth of overseas investments really started to build momentum in 2002 as China opened up and joined the World Trade Organization. The impact was swift, Chinese companies grew quickly as they capitalised on new found knowledge, invested their cash reserves and leveraged special loans or state aid available to them.
Accompanying domestic companies in their international development provides a strong incentive for the internationalization of banks in emerging countries. This is the hypothesis of the well-known “follow-the-customer” theory and is not only applicable to Chinese banks. It demonstrates that banks are keen to settle in foreign countries that hold strong trading relationships with the domestic market. Two examples are:

**Vietnam** - ICBC’s move into Vietnam in 2010 is a good example: Chinese official statistics showed that China had been Vietnam’s largest trade partner for six consecutive years with Chinese companies’ investing up to US$3 billion.

**Thailand** - In November 2010, ICBC made the acquisition of ABL Bank to become ICBC Thai, following the business expansion of a number of Chinese companies in Thailand including: China State Construction Engineering Corporation (CSCEC), Huawei, ZTE and Haier.

The installation of banks in foreign countries also boosts opportunities for new companies from the two countries to cooperate: Banks “show the way” to their customers helping them to set up businesses in the foreign countries. They could be described as forerunners for the domestic economy expansion abroad. Xiao Gang, chairman of the board of directors of Bank of China wrote in July 2012: “There is good reason to believe that the Chinese economy has reached a point where its status as the biggest country will lead it to become the biggest in outbound direct investment. This new model not only requires Chinese enterprises to expand their global businesses, but also China’s banking sector to accelerate its internationalization”.

**Chinese banks have a considerable advantage over their foreign competitors to address the needs of Chinese businesses.** From establishing credit lines, financing day-to-day operations to providing a streamlined financial system that allows the easy transfer of money between the mainland and international locations.

Looking at the figures, although the European Union is China’s largest trading partner (see Table 2 below), it seems that Chinese banks have remained cautious with respect to their European counterparts in terms of M&A operations. Despite the fact that European countries had been publicly identified by Wang Hongzhang as strategic targets for an acquisition back in 2012, low growth and lack of dynamism in Europe and the U.S. have encouraged Chinese banks to turn their attention to emerging countries that offer sustained economic vitality and high potential for development such as those in Africa or Latin America.

ICBC the most active Chinese player on the international stage - has focused US$7 billion on acquisitions in the Asian, South African and American region. Its record for an M&A transaction abroad amounts nearly US$5.5 billion for a 20% stake in Standard Bank in South Africa in 2008.

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3 Grubel 1977, Walter 1988
4 President of CCB
Table 2. Top 3 China’s trading partners - Data as of 2011 – Amounts in billions US$

<table>
<thead>
<tr>
<th>Region</th>
<th>Chinese Exports</th>
<th>Chinese Imports</th>
<th>Trade balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Union</td>
<td>356</td>
<td>211.2</td>
<td>+144.8</td>
</tr>
<tr>
<td>United States</td>
<td>324.5</td>
<td>122.2</td>
<td>+202.3</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>268</td>
<td>15.5</td>
<td>+252.5</td>
</tr>
</tbody>
</table>

In 2006, the China Construction Bank bought the wholly owned Asia subsidiary of Bank of America; in order to expand its businesses and network across North America, ICBC acquired 70% of the Canadian operations of Bank of East Asia in 2010. In November of the same year, ICBC also took over the brokerage activities of BNP Paribas Fortis in the United States for $1. According to the Wall Street Journal, their plan was to use it as a base to expand its underwriting of securities in the U.S. market and to avoid tight U.S. regulatory restrictions on foreign purchases of deposit-taking institutions.

With this transaction, ICBC became the first Chinese bank to get into the broker-dealer business in the U.S. In 2012, ICBC took an additional crucial step by becoming the first Chinese bank to enter the United States retail banking market, when they acquired the network of 13 branches (across California and New York) of Bank of East Asia in a deal worth US$140 million.

Evidence of the far greater integration of Chinese banks into the American market was clear last February when, ICBC celebrated its first anniversary as a member of the New York Stock Exchange, the first Chinese institution to own a seat on this prestigious exchange.

Even if the strategy of banks to set up shop overseas is primarily to foster links between Chinese enterprises and foreign markets as part of the “Going Global” strategy, it is also an imperative for Chinese banks to follow their major customers as they relocate or travel overseas. In 2012, there were 3 million Chinese living in Europe (expatriates, students...) and millions of tourists visit the Europe each year. Liu Xiaoming, Chinese ambassador to the UK says “The London branch (of BOC) has drawn a diverse customer base by cultivating customers from local Chinese-ethnic communities and businesses”.

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5 China testifies a surplus in trade balance with European Union equal to USD 144.8 billions

6 In 2000, nationals from the People’s Republic of China who legally reside in Europe was estimated at 200,000
Chinese Banks expansion to secure the access to natural resources

One of the biggest challenges facing China is the need to secure access to natural resources. In 2003, China became the second largest consumer and third largest importer of oil. Beijing now imports 40% of its oil, a figure that could double by 2025. According to statistics released by China's Ministry of Commerce, Chinese outbound investment related to energy and resources will dominate in the next few years. In 2012, 15% of China's outbound direct investments were directed at the mining industry, and more than US$1 billion went to the energy and resources-related industries, in particular the production and supply of electricity, steam, gas and water.

Chinese banks are helping Chinese firms by providing them with competitive rates and giving them access to natural resources at a lower cost compared to competitive firms. This goal explains the moves of Chinese banks toward a number of markets such as Africa, Middle East, Latin America, Canada and Australia.

In Africa, Chinese institutions have been leading aggressive expansion in strategic zones where energy sources are located. Entities such as China Development Bank (CDB), Industrial and Commercial Bank of China (ICBC), China International Trade and Investment Corporation (CITIC), China Export and Credit Insurance Corporation (CECIC), Sinosure and the China Export-Import Bank work closely with Chinese oil corporates in order to set preferable financial deals for African natural resources. Chinese financial institutions have operated strategic M&A operations with key African players to underpin their financial strategy in the continent sustainably. ICBC was the first Chinese bank to adopt this strategy purchasing a 20% stake in South Africa’s Standard Bank in 2008. This has enabled ICBC gain a foothold in 18 African countries in which Standard operates. Other examples are the, China Development Bank who acquired a US$7 billion stake in the UK’s Barclays Bank, an institution with dominant positions in resource rich nations such as Nigeria, South Africa, Zambia, and Zimbabwe. More recently in 2013, Bank of China entered into a strategic business cooperation with Nedbank, one of the largest banks in South Africa.

The relationship between ICBC and Standard Bank has been fruitful; they partnered not only to expand in Africa but also to move into the fast-growing Latin American market through its purchase of an 80% controlling stake of Standard Bank's Argentine operation for US$600 million cash in 2012. This acquisition gave ICBC access to the local market including 103 branches across the country, where Chinese companies have been investing heavily in the mining and manufacturing industries.

In the same year, ICBC was celebrating in the Peruvian capital, Lima with the opening of the first fully-owned Chinese commercial bank in Latin America there. The Chinese presence in Peru is most notable in the mining sector, which accounts for about 60% of total Peruvian exports. Chinese interest in Peru has also extended to the energy and fishing sectors. ICBC is also present in Brazil, the country with the largest population and economy and the largest financial services market in Latin America. More recently in November 2013, China Construction Bank announced that it had reached an agreement regarding the acquisition of 72% of total share capital in Banco Industrial e Comercial S.A. in Brazil.
Further North, the China Development Bank has focused more on the natural-resources-related loan business in Venezuela. The Oil-rich nation has become the largest foreign borrower of CDB with more than US$28 billion in loans issued so far. The late Venezuelan President Hugo Chavez announced on state television that CDB was "the bank with the most money in the world. It has half the money in the world and is allied with Venezuela".

The Middle East is also appealing not only for its natural resources but also for the flourishing business opportunities it offers. By the end of 2007, non-financial direct investment from Chinese enterprises in the United Arab Emirates amounted to US$180 million, involving sectors such as petroleum, petrochemical, telecommunications, trade, project contracting, logistics and real estate. There were more than 3,000 Chinese-funded companies registered in the UAE. Continuous development of economic and trade exchanges between China and the UAE, as well as growing demand for investment has created more demand for financial cooperation between both countries. In this context, in 2008 a grand opening ceremony was held in Dubai for the creation of “ICBC Middle East”, giving the Chinese giant a foothold in the economic and financial centre of the United Arab Emirates. In November 2012, the board of directors of ICBC announced that the bank had received regulatory approval to set up branches in the Middle Eastern markets of Kuwait and Saudi Arabia, the Arab world’s largest economy and primary source of oil for Asia.

Will the Renminbi become the next global currency?

With the expansion of Chinese banks into offshore markets China’s central bank, the People’s Bank of China (PBOC) will gain more influence on the global stage. The increase in commercial trades bringing Chinese businesses to the international stage is likely to encourage a major use of Renminbi to settle international payments. This in turn will give the Chinese government more influence with the World Trade Organization (WTO) and International Monetary Fund (IMF).

According to a study published by Deutsche Bank, the total of Renminbi denominated international trade will increase by 50% in 2014. Evidence of demand for trading with the Renminbi is a positive sign for the currency’s prospects as a key global currency and as a potential rival to the dollar. However as the Bank of China Chairman Xiao Gang points out: “China accounts for about 14 percent of global trade, while the Renminbi only accounts for less than 2 percent in global trade settlement.”

The springboard for the Renminbi was in 2008, when People’s Bank of China (PBOC) started promoting the currency for cross border transactions by passing the “Administrative Measures for Pilot Implementation for RMB Settlement in Cross-border Trade” legislation. Since 2008 the PBOC has signed currency swap agreements with 24 foreign central banks, including the European Central Bank.

Last October, the two institutions signed a major swap agreement: The swap line will be valid for three years and have a maximum size of 350 billion RMB (US$57 billion) when Chinese currency is provided to the ECB and 45 billion euros (US$61 billion) when money is given to the PBOC. This

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7 As of 2013 data
8 Chairman of the China Securities Regulatory Commission He was previously chairman of the board of directors of Bank of China Limited and Bank of China (Hong Kong) Limited.
agreement is valid in all Euro system zones through local central banks. Hong Kong currently has the largest swap agreement at 400 billion RMB (US$ 66 billion); followed by South Korea with 360 billion RMB (US$ 59 billion); the ECB’s is the third-largest. In Hong Kong, the amount of “dim sum bonds” - bonds issued in RMB – is five times, that of two years ago, an equivalent of US$67 billion (406 billion RMB). Today we are seeing, more and more international companies and banks issue or invest in products denominated in Renminbi.

Now major financial centers are interested in playing a role in the internationalization of the Chinese currency and there is a fierce competition between them to clinch an increasing share of international transactions. London, New York, Paris and Singapore have expressed to be keen to become offshore Renminbi trading centres. Among them, only London won official support from China last year however, Singapore could play a crucial role as a bridge between East and West. Major Chinese banks such as ICBC and Bank of China are in talks with the French Finance Ministry to help Paris strengthen its position as a European centre for Renminbi trade, while about 10% of trade between China and France is Renminbi-denominated. In the Middle East, Dubai is seeking to become a Renminbi clearing and settlement hub where banks including HSBC and Standard Chartered are already offering Renminbi-denominated accounts to their customers. Luxembourg, where most of major Chinese banks have their European headquarters, is also an important place for Chinese currency promotion: On February 26th 2013 the “Luxembourg Renminbi Forum” was held, bringing together 300 European key experts in the financial sector to promote the internationalisation of Renminbi.

China's central bank has stated that Renminbi would become "basically convertible" by 2015. Beijing officials have indicated that Renminbi should be included in the “basket of currencies” held by the IMF in the upcoming years. The current Special Drawing Right (SDR) is made up of four currencies—the Euro, Yen, Dollar and Pound—but current regulations require that SDR basket currencies have to be issued by a major export country, and the currency must be considered “freely usable.” A currency is generally considered “freely usable” once it is used as a unit of account, such as corporate invoices or as a medium of exchange, in settling cross-border transactions, and as a store of value, including deposits and reserve currency. The internationalization of Chinese banks and the ambition of Shanghai to become a major financial center have helped to make Renminbi an indispensable currency in international trading in order to reach this objective.

What does the future hold?

Chinese firms are divided between two main objectives: how to limit risk exposure whilst capitalising on opportunities in emerging market developing countries.

The impact of the global financial crisis of 2008 reinforced this trend by creating an uncertain economic environment in Europe. This on one hand offered opportunities to acquire vulnerable European companies at a lower cost and on the other encouraged the redeployment of Chinese investment toward valuable energy resources in regions such as Africa and Latin America.
Today, China’s appetite for commercial expansion seems to be driven by the need to access natural resources, already a significant factor underlying its foreign investments from the previous period. It is not only Africa, Latin America and the Middle East that are attractive but also countries such as Australia and Canada are proving to be popular destinations for Chinese investors.

However, the major developed markets (Europe and North America) still remain strategic destinations for Chinese investment, after all it is these markets that have driven growth in recent years through exports of manufactured products to these countries. Moreover, these developed countries still offer China undeniable advantages over Asia, Africa and Latin America in terms of political stability, purchasing power, legal framework, export market opportunities and access to a pool of companies with unique know-how and skills that are attractive to Chinese investors.

Even though Chinese banks have been able to establish operations in foreign markets in a very short timeframe, they still largely cater to Chinese businesses and often lack the prerequisite language skills and knowledge of local culture and regulations necessary to compete for local clients. Whilst this will protect local rivals in the short term, Chinese institutions are already working to overcome these barriers, and in many cases recruiting highly skilled people to manage financial institutions for them.

For further information, questions or to arrange a meeting for us to discuss any of the issues raised in this paper, please contact Sia Partners HK.

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