China's Banking System and How Citibank Can Capitalize on its Liberalization

Master of Arts in Law and Diplomacy Thesis

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Executive Summary

The potential that China's economy holds as it moves to a more liberal market economy is limitless, and Western firms are eager to become the first movers in their industries to take advantage of this promise. Western banks are no exception. Chinese regulations have historically limited the operations of foreign banks, but with the entry of China into the World Trade Organization, that is all slated to change- in theory. Geographic limitations for foreign banks are to be lifted by December 2006, along with a host of other restrictions that have retarded the growth of these Western banks and the Chinese banking sector as a whole. Progress on these liberalizations has been slow, however, and Chinese regulators have even put other limitations in place that will hurt competition in the long run.

This is far from the only problem facing the Chinese banking sector. Decades of policy lending have saddled the four state-owned banks with an unhealthy level of non-performing loans from state-owned enterprises. Asset management companies have been created to manage these NPLs, but the situation is far from stable. A lack of corporate governance has also created an environment where management of banks is opaque and corruption widespread. The risks inherent in this industry are great.

In this environment then, what is Citigroup's best method of operation? Once reentry to the market was allowed, Citigroup pushed hard to maintain its control in China by avoiding joint ventures and operating independently. As this strategy stalled and its competitors gained the upper hand in the country, Citibank changed its approach to embrace joint ventures and entertain the idea of buying into the state bank system. Is this the right approach?

Citibank is right to pursue joint ventures at this time, especially because building its own structures in China would be cost-prohibitive and too slow to develop. At the same time, the bank must be careful with whom it associates in China. The possibility of corruption or mismanagement is still significant with regard to partnerships with state-owned banks. It also cannot expand its offerings too quickly or expose itself to too much risk. It should use its government connections to speed up the deregulation process, plan for the time when this becomes a reality, and train native Chinese workers in Western bank practices. Citibank is currently not the most successful foreign bank in China; that title belongs to HSBC. A combination of prudent growth and innovative service upgrades should allow Citibank to compete with and eventually overtake its rival in this burgeoning market.

Introduction

Midway through 2005, Citibank still faced significant barriers to growth in China. It had worked hard to become the dominant foreign bank in the country in expectation that the country's banking sector would be opened to all competition in late 2006. The changes mandated by the WTO had been slow in coming, if they had happened at all. The Chinese government had removed some of the legal barriers to entry in some areas, but had erected new ones elsewhere, including raising reserve requirements to unprecedented levels. In addition to regulatory problems, Citibank faced serious problems in its own approach to strategy in China. It had initially been aggressive in pursuing every opportunity to buy into Chinese domestic firms as a way to gain an advantage on its foreign competitors. This strategy hadn't produced the results that had been expected, however, and the firm decided to change its approach in early 2005 to try to stanch the bleeding. How should the firm change its approach to put itself in the driver's seat on January 1, 2007?

Historical Chinese Banking System

The modern Chinese banking system was created in the 1950s and was characterized by an all-inclusive mono-bank system.[1] The People's Bank of China was the main conduit through which all banking activities traveled. According to Nicholas Lardy:

> "The People's Bank of China, with a vast network of over 15,000 branches, sub-branches and offices, dominated China's financial landscape. It controlled almost

[1] Yi, Gang. Money, *Banking, and Financial Markets in China*, (Westview Press, San Francisco, 1994) Page 19.

> four-fifths of all deposits in banks and credit cooperatives and was the source of 93 percent of all loans by financial institutions. The People's Bank simultaneously served as China's central bank, regulating the money supply, fixing interest rates, managing the state's holdings of foreign exchange, and supervising and controlling all other financial institutions."[2]

The People's Bank of China, however, was not the only bank in China. Two other main banks, the Bank of China and the Construction Bank of China, fulfilled more limited roles in the banking system, and many other rural credit cooperatives filled in the gaps in the countryside. The Bank of China's operations were subordinate to those of the People's Bank and consisted of the handling of foreign exchange and international payments. The Construction Bank of China operated as a subsidiary of the Ministry of Finance and its role was simply to disburse fixed investment funds for projects that were incorporated in the state economic plan and financed through the state budget.[3]

Sayuri Shirai writes that:

> "Prior to 1979, the PRC's banking system was not modern and played only a limited role in promoting economic growth. This reflects the limited role of banks in a highly centralized planning system whose primary functions were collecting revenue from state-owned enterprises (SOEs) and allocating investment through budgetary grants (Ma, 1997). In this circumstance, banks simply provided credit

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[2] Lardy, Nicholas. *China's Unfinished Economic Revolution*, (Brookings Institution Press, Washington, DC, 1998), Page 61.
[3] Ibid.

> needed by SOEs for their production plans and provided/monitored cash used principally to cover labor costs and purchases of agricultural products."[4]

Over time, the Chinese government recognized the need to modernize its banking system due to significant inefficiencies in the allocation of capital and the increasing interaction with the outside world. Beginning in 1979, China began to undertake sizable changes in the way that its banking system was structured. These changes started with the separation of individual banks from the People's Bank and moved on to more complicated and dramatic actions.

In February of 1979, the Agricultural Bank of China was reorganized and relaunched as a bank separate from the People's Bank. According to Lardy, "this move reflected the priority that the Communist Party assigned to agriculture in the initial stage of economic reform and its assessment that an infusion of funds was central to reviving growth in the farm sector."[5] The next month, the Bank of China was broken out from the People's Bank and made directly subordinate to the State Council. The bank's scope of action was widened at the same time to make it the primary support as China opened its economy to the outside world. A similar action was taken with the Construction Bank in October of 1979. This bank was removed from the administrative control of the Ministry of Finance, placed under the same administrators as the rest of Chinese banks, and began to accept deposits in 1980.

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[4] Shirai, Sayuri. "Banks' Lending Behavior and Firms' Corporate Financing Pattern in the People's Republic of China", ADB Research Institute Paper 43, September 2002, Page 8.

[5] Lardy, Page 62.

Administrative and financial reform continued to take place throughout the 1980s. Among the more notable reforms were:

- The creation of the China Investment Bank to control the disbursement of funds from the World Bank, which accepted China as a member in 1980.
- The creation of the China Investment Bank in 1986 to disburse funds from the Asian Development Bank, which brought China into the fold in that same year.
- The reorganization of the People's Bank branch network to form the Industrial and Commercial Bank of China in 1984.
- The gradual introduction of foreign competition into the Chinese banking sector.

The most important change made to the Chinese banking system during this period, however, was the creation of a true central bank by the State Council in September 1983. Previously, the People's Bank was responsible for all banking functions in China, including both lending responsibilities and tasks that a central bank fulfills. Lardy notes that, "Beginning in 1985 the People's Bank was responsible for issuing currency, managing credit, setting interest rates, and supervising China's foreign exchange business. It set reserve requirements for the specialized banks, promulgated credit targets, and adjusted the flow of funds across banks in different locales."[6] While the moves discussed before the creation of the central bank were important, this action signaled to the rest of the world that China was truly going to modernize its banking system, however slowly this might take place.

[6] Lardy, Page 64.

Recent Changes to the Banking System

Despite these reforms, the Chinese government has recognized that the reorganization of its banking sector still requires a good deal of work. The 1990s brought still more adjustments to the banking system in China. The Federal Reserve Bank of San Francisco observes four major changes in policy that have come about recently[7]:

1) **Strengthening bank balance sheets-** China has adopted a strategy of recapitalization of its state-owned banks in the hopes that they will eventually all have the opportunity to become publicly owned companies. The government issued $32 billion in bonds to recapitalize the four major state-owned banks in 1998. In 2000, four asset management companies (AMCs) were created to take ownership of the non-performing loans (NPLs) of each of the four state-owned banks. The total amount of NPLs is estimated at $170 billion, but in reality, no one is sure how much debt can be classified as non-performing. The FRBSF writes that. "Chinese banks are also adopting balance sheet criteria that reflect international practices; for example, as recommended under the 1988 Basle Accord, risk-based capital ratios of 8% are being maintained."[8]
2) **Using commercial lending criteria-** Whereas the largest state-owned banks were once required to lend based on government policy, their emphasis has now shifted to require lending based on generally accepted commercial banking techniques. These criteria include lending against collateral, assessing borrower creditworthiness before lending, limiting loans to single lenders to no more than

[7] Federal Reserve Bank of San Francisco. "FRBSF Economic Letter." Number 2002-17, May 31, 2002.
[8] Ibid, Page 2.

10% of the bank's capital, and a requirement that the loans are repaid in a timely fashion.

3) **Strengthening SOE finances and management-** While improvements in the banking system are required, government officials are also restructuring SOEs, the sources of the NPLs, to ensure that the situation does not continue. SOEs are slowly downsizing, are required to limit spending, and can no longer assume that the state-owned banks will offer unlimited credit.
4) **Improving governance-** Chinese firms now recognize the importance of corporate governance, both in terms of general improvements in efficiency and their ability to attract outside investment. Some of the improvements in governance have come about as a result of these companies listing on outside stock exchanges, which require a certain level of transparency and oversight. Others companies will follow. In the end, it is hoped that these improvements will both improve the operations of these firms, as well as limit the chances for mismanagement and the conversion of bank loans to the non-performing category.

Risk Factors in the Chinese Economy

While the Chinese economy is booming at the moment, it is far from stable. Any economy that experiences growth like China has will be more vulnerable to global economic conditions, and the developing nature of China's market means this is even more of a truth. Questions about the long-term stability and viability of the Communist regime will always top the list of risks of doing business in China, but there are specific problems with the banking sector that should concern any entrant to the country. The legacy of policy banking has created an environment that lacks a culture of lending accountability. Banks like Citigroup need to be conscious of the following related factors when continuing to expand in China:

- Non-performing loans- The Communist system of awarding loans to state-owned enterprises (SOEs), whether they are profitable or not, has lasted until the present day and has saddled these banks with an unwieldy percentage of NPLs. It is impossible to provide an accurate percentage of NPLs among the total number of Chinese bank loans, but even after an enormous government injection of $157 billion into Chinese bank coffers in 2000, the most optimistic estimate of Chinese NPLs stood at 30% of all outstanding loans[9]. Modern banking theory contends that if this percentage stands higher than 5%, warning signals should be sounded. This places Chinese banks, and indeed the entire Chinese economy, in a precarious position.
- Term structure of foreign banks loans- As mentioned above, if a large number of bank loans are issued in foreign currencies and in maturities of one year or less, it leaves a national banking system at risk of a quick fund pullout in case of a crisis. Due to a lack of lenders issuing loans in renminbi, corporations have been forced to borrow in foreign currencies and in terms of less than one year in order to lower their cost of capital. If there is a devaluation in the value of the renminbi, companies may be unable to repay their short-term loans. In this case, Chinese banks would

[9] Gordon G. Chang, *The Coming Collapse of China*, (Random House, New York, 2001), Page 124.

have to rely on the huge amount of personal savings that they have accumulated from the public to remain afloat. It is logical to think that a bank rush would result from a devaluation of the Yuan, however, and these savings would also disappear, leaving the banks without the means to continue operations.

- Profitability of banks- An annual systemwide return on assets (ROAs) of less than 1% for retail banks and/or an annual net interest margin of less than 2% are often signs of a crisis. As a result of the high number of NPLs, Chinese banks are not profitable according to Western standards of accounting, meaning that they are more vulnerable to fluctuations in local and world markets than other Western banks.
- Rapid growth or collapse of international money and capital flows- China has experienced a tremendous explosion of foreign capital inflows over the past four years. This capital has provided much of the fuel for the Chinese economy to continue its growth. As the Chinese economy has liberalized, however, much of this capital is more liquid than it has been in the past. Corporate governance and banking laws are not sophisticated enough to manage this inflow well enough, and if these investors panic about the state of the legal system, this capital can be withdrawn. An event such as this could be a trigger for a meltdown of the Chinese economy.

China's Asset Management Companies

The Chinese government recognized that if it wanted to make its state-owned banks competitive in the current world economic environment, the issue of non-performing loans had to be addressed. In order to do this, the government established asset management companies to collect the NPLs at book value; restructure or assign NPLs; convert NPLs into equity; issue financial bonds and borrow from financial institutions; and, recommend companies for listing.[10] These AMCs purchased the NPLs that were extended prior to 1996 by issuing bonds valued at RMB850 million and borrowing RMB 55 million from the Chinese government. According to Pei and Shirai:

> "The quality of the transferred NPLs was extremely poor. More than 70% of the debt assets are credit loans, which are largely loans made by the state-owned enterprises for investing in equipment and production capacity. Quite a few of the loans include those guaranteed by the government. It has been pointed out that 40% of SOCBs' assets are NPLs and should be written off."[11]

In general, the AMCs have used two methods to dispose of their NPLs. AMCs have either conducted debt-equity swaps for SOEs that are better-performing and more attractive to foreign investors or dealt the NPLs of firms that are unlikely to survive to outside investors. This second method has proven to be most attractive to foreign investors. Current regulations forbid the direct acquisition of NPLs by foreign firms, so joint ventures must be created in China to purchase these loans. Pei and Shirai write that,

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[10] *Guifen Pei and Sayuri Shirai, "*The Main Problems of China's financial Industry and Asset Management Companies." February 4, 2004. Habei University and Keio University. Accessed at http://coe21-policy.sfc.keio.ac.jp/ja/event/file/s1-7.pdf. Page 10.

[11] Ibid, Page 11.

"The ICB and the CCB established venture entities with Morgan Stanley and Goldman Sachs, respectively, to dispose of their NPLs. These banks have begun to deal directly with foreign investors regarding their NPL portfolios and are considering auctions, as well as private placements, despite the current regulatory restrictions. The regulatory hurdle facing China's domestic banks in doing private deals with foreign investors is found in Article 43 of the *Commercial Banking Law*, which prohibits commercial banks from investing in non-banking financial institutions; but the article may be overlooked in the near future."[12]

WTO Mandates

During the accession talks between China and the World Trade Organization, a number of demands were placed on the Chinese that would force the country to reform its banking sector and make it more accessible to foreign competition. *The Economist* describes these changes by writing:

> "Agreements that the Chinese authorities negotiated with foreign countries before the country's December 2001 entry into the trade body require the gradual opening of the banking, insurance and fund-management sectors. Other sources of change to the financial sector are attributable to the rise of domestic investment banks and securities brokers, the re-incorporation of Hong Kong and Macau under Chinese sovereignty and official efforts to manage bad bank debts through specialized asset managers."[13]

[12] Ibid, Page 14.
[13] *The Economist* Intelligence Unit, "Country Finance: China," Released August 2004.

After accession to the WTO, the Chinese domestic banking sector was to be deregulated as follows:

1) The limitations on geographic coverage were to be gradually lifted. There would be no geographic limitations for foreign currency businesses, and local currency restrictions were lifted on a city-by-city basis. Within five years after accession, all geographic limitations would be lifted.
2) The restrictions on clients would be gradually lifted. For foreign currency businesses, foreign financial institutions would be permitted to provide services without restriction as to clients upon accession. For local currency business, foreign financial institutions would be permitted to provide services to all Chinese clients within two years. [14]

These changes were to be made in addition to liberalization in the insurance and securities sector, which also had to meet their own benchmarks in order to comply with the WTO accession agreement. These changes have come about much more slowly than mandated, however, and the Chinese government has even erected artificial barriers to restrict foreign competitors when the WTO-mandated changes have been made. *The Economist* notes that:

> "Working capital requirements for banks in China are high, more than 15 times higher than those required in the EU, according to the European Chamber of Commerce in China. These requirements make it very expensive for foreign banks to expand- for example, HSBC's head office injected Rmb435m (US$52m) into its

[14] Kui, Liang; Shuyan, Guo, et. Al. *The SWOT Effects of the Openness of the Financial Market After China's Entry to the WTO*.

China operations to allow three of its branches to begin providing renminbi services to foreign enterprises and individuals in 2003- but do not violate clearly the terms of China's accession to the trade body."[15]

The Economist also writes that even those banks that can handle the reserve requirements are prevented from opening more than one new branch per year.[16] In addition to these rules, China has mandated that those banks wishing to operate in the renminbi business must have been engaged in operations in China for the previous three years. Furthermore, those operations must have been profitable for two of those three years.[17] These are clearly significant barriers to entry for any foreign bank, and the presence of these barriers means that only the largest and most well-connected foreign banks can operate in China.

Operations Strategy of Foreign Banks in China

Due to the Byzantine restrictions placed on foreign banks in China, each bank has had to decide on the best way to capture market share while still operating within the boundaries set by the Chinese government. Over the past five years, several trends have arisen among foreign banks.

1) **Anglo-Saxon Approach**- The three major American financial corporations in China, HSBC, Citibank and AIG, have taken an aggressive approach to consolidating market share. According to *The Economist*, "All three firms have

[15] The Economist Intelligence Unit, "Coming of Age: Multinational Companies in China." (London, June 2004). Page 70.
[16] Ibid.
[17] Conklin, David, W. Case Study: Citigroup in Post-WTO China. (Richard Ivey School of Business, Ivey Management Services, 2002). Page 4.

been rolling out new branches as quickly as they are allowed, and moving into new product markets as soon as regulations permit them to do so, most recently credit cards for consumers and renminbi loans for domestic companies."[18] In addition to these individual steps, each institution has partnered with Chinese banks in order to expand the services that they are able to offer. For example, Citigroup has partnered with Shanghai Pudong Development Bank in a deal where Citigroup purchased 4.6% of the bank's shares, which increased to 5% in November of 2003.[19] HSBC, however, has been most aggressive in pursuing these links. In December of 2001, the international financial giant bought 8% of Bank of Shanghai and followed that ten months later with the purchase of a 10% interest in Ping An Insurance. HSBC's Hong Kong subsidiary, Hang Seng Bank, owns 16% of Industrial Bank and also purchased 100% of a Sino-foreign JV firm, Fujian Asia Bank.

These three companies have been able to take such an aggressive approach in China because their size and profitability allows them to do so. *The Economist* notes that HSBC's purchase of Ping An and Bank of Shanghai cost them $663 million. Very few firms can make such an investment knowing that the investment will not pay off in the short-term. In addition, these three firms have experience in developing markets and aren't scared by the country risk involved in such investments. These three also have significant experience in China itself and the first-mover advantage is undeniable in a market where government links and access are vital.

[18] "Coming of Age," Page 78.
[19] He, Liping; Fan, Xiaohang. "Foreign Banks in Post-WTO China: An Intermediate Assessment." Excerpted from *China and World Economy*, Vol. 12, No. 5, 2004. Page 7.

2) **Continental European Approach**- the approach taken by European firms has been more low-key and more diversified than that of its Anglo-Saxon competitors. According to *The Economist*:

   "The business interests in China of the German financial services group, Allianz, include its wholly owned bank, Dresdner, a general insurance operation in the southern city of Guangzhou, and a JV life insurance company in Shanghai with China's Dazhong Insurance. In addition to its fund management JV with Haitong Securities, Fortis has a banking presence in three cities in China and a 24.9% stake in one of China's smaller but rapidly growing life insurance firms, Taiping Life. ABN Amro has a larger retail bank presence than its continental European counterparts and in February 2003 it purchased a 33% stake in an existing fund management company, Xiangcai Hefeng Fund Management. It is also working to sell investment products to China's domestic financial institutions."[20]

3) **The Specialist Approach-** This third strategy has been most effective for smaller firms without the reach and size of the largest international financial institutions. Rather than aggressively buying whichever bank becomes available, or expanding their reach to as many sectors as possible, these smaller firms have chosen more specialized segments in which they can excel and focused their energies on them. This strategy has mainly been used by insurance firms and fund managers to limit their exposure in China until the market becomes more predictable. For example, both Chubb Insurance and Royal Sun Alliance have limited themselves to wholly-owned general insurance ventures in Shanghai and have so far refused to enter into any joint-venture agreements or purchases of Chinese firms.

[20] "Coming of Age," Page 78.

Citibank's Operations in China

This case earlier stated that Citibank had been especially aggressive in pursuing purchases of Chinese firms and beginning partnerships with others to strengthen its chances of success in 2006. This is somewhat misleading, as Citibank has operated in China for more than a century and has a long history of goodwill in the country. The company began operating in China in 1902, and by 1930 was one of the country's largest and most important banks. Citibank had opened 14 branches in nine cities, but the flowering of the Communist revolution meant that those branches were subsequently closed. Citibank was finally allowed to reopen an office in Shenzen in 1984 and slowly began to rebuild its base and reopen its ties with the Chinese government. According to David Conklin, this process was easier than it was with other banks. Conklin writes that, "The bank had a well-established reputation for commitment too, which made Citibank popular with governments: Unlike some other banks which moved into countries on the expectation of brisk profits and then moved out again when they were slow to materialize, Citibank moved in early with intent to stay."[21]

Citibank's strategy in China has evolved as the business environment has changed over the past decade. At first, Citibank avoided joint ventures with any Chinese domestic partners, instead preferring to operate any offices in China as branches and not subsidiaries. According to Chris Tibbs, who was the vice-president and head of corporate finance in China for Citibank in 1997:

[21] Conklin, Page 15.

> "We recognize that most JVs do not last very long. JVs give an institution a short-term advantage, but not long-term benefit. A JV in China would be an expensive practice. We do not think that we need to do a JV in China. Up to three years ago, many institutions favored JVs. Now they realize that the environment in China is such that it is unnecessary for them to do JVs in order to get business. Today, foreign institutions are looking for majority shares of the partnership, or even 100% ownership. The expansion of Citibank in China may be possibly through merger and acquisitions instead of joint ventures."[22]

To implement this strategy, Citibank continued to open new branches in major Chinese cities as quickly as the government would allow. In reality, however, the speed with which the bank could open new branches was not very fast at all. On March 4, 2005, Citibank opened a consumer banking branch in Shenzen. This opening brought the number of Citibank offices in China to just 13- five corporate banking branches – Beijing, Shanghai, Guangzhou, Shenzhen and Tianjin; six consumer banking outlets – Beijing, Shanghai, Tianjin and Shenzhen; and two representative offices in Xiamen and Chengdu.[23] Citibank also pressed ahead with its government relations and public affairs lobbying and became the first foreign bank to offer renminbi services in 2002. It was also the first bank to offer banking services to Chinese consumers in 2002, as well as the first international bank to launch two new investment products, Premium Accounts and Market Linked Accounts, in China.[24]

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[22] Conklin, Page 19.
[23] "China: Citibank Opens New Consumer Bank Branch in Shenzen." Corporate press release, March 4, 2005. Accessed at http://www.citigroup.com/citigroup/press/2005/050304a.htm.
[24] Ibid.

While these were all significant developments, Citibank was not pleased with the slow pace of growth in its Chinese operations. The regulatory changes that Citibank had expected never materialized and as a result, the bank was unable to offer the bulk of the services most important to profitability in China. Due to this situation, the bank's 2001 annual report announced a change in strategy in China:

> "Our goal is to grow our market share over the next five years through our embedded bank strategy. By 'embedded bank' we mean a bank that has roots in the country as deep as any local indigenous bank, building a broad customer base, offering diverse products, actively participating in the community and recruiting staff and senior management from the local population. Our long history in these regions positions us as a genuinely local bank."[25]

To reach this goal, Citibank took the bold decision to buy a stake of a domestic Chinese bank in order to offer more of its services to Chinese customers. In December of 2002, Citibank bought a 5% stake in Shanghai Pudong Development Bank (SPDB) for $67 million. The decision to buy into SPDB may seem odd at first glance, but Citibank's country officer for China, Richard Stanley, stated at the time that, "SPDB was not a difficult choice of partner."[26] The *Far Eastern Economic Review* wrote that,

> "Unlike the big four state banks with their thousands of branches and hundreds of thousands of employees, SPDB has just 242 branches nationwide and 6,000 staff. More importantly, its nonperforming loan ratio, at around 5% of total loans,

[25] Citibank, N.A. *2001 Annual Report*. Page 20.
[26] Tom Holland and Paul Beckett. "Citigroup's China Bet." *Far Eastern Economic Review*, March 6, 2003. Accessed at http://fox.rollins.edu/~tlairson/asiabus/citigroupchina.html.

> is far lower than those at the big four, where bad-loan levels are estimated to be anywhere between 30% and 50%. "[27]

Several letters of understanding were signed by the two partners at the time of the partnership. According to these letters, SPDB would “introduce Citibank's management, technology and staff to run its credit card business on the Chinese mainland. Citibank has also promised to provide a credit loan to SPDB of up to US$20 million. The two banks will also establish a 50/50 joint venture company to manage the credit card business if the Chinese law allows. Citibank said it would help SPDB to improve the Chinese bank's overall performance and profit to become a commercial bank in line with international standards.”[28]

The lengthy negotiation process between Citibank and SPDB took place with the understanding that the two banks would offer a credit card as their first joint venture. The card was unveiled in May of 2004; according to China Daily, “The launch of the card, the first on the Chinese mainland in co-operation with a foreign bank, is the prelude to the setting up of a joint venture credit card company by the two banks when they are legally permitted to do so.”[29] The card will allow Chinese travelers to use foreign currency and get US dollars when abroad. It can also be used locally in renminbi. According to Charles Prince, Citibank’s CEO, “The card has a lot of features that we offer to the cardrunner, such as privileges, being able to settle benefits and gain discounts

[27] Ibid.
[28] Wire report, “Citibank and Pudong Development Bank Boost Cooperation.” *People’s Daily Online*, April 23, 2003. Accessed at: http://english.people.com.cn/200304/25/eng20030425_115762.shtml
[29] Chang Tianle, “Citigroup, SPDB launch joint credit card.” *China Daily*, May 2, 2004. Accessed at http://www.chinadaily.com.cn/en/doc/2004-02/05/content_303342.htm.

around the world. I think it will be a differentiated product in the market."[30] Reports in the local Chinese press report a rumor that Citibank plans to increase its stake in SPDB annually, and by 2008, plans to hold the legal limit of a 25% of SPDB.

The partnership with SPDB, however, is only one aspect of Citibank's change in strategy. Rumors continue to circulate that Citibank is interested in purchasing a stake in China Construction Bank (CCB), which has pursued a listing on the Hong Kong stock exchange. According to SinoCast China Financial Watch, buying into CCB would, "enable Citigroup to make inroads into the fast-growing mainland bank card industry and home loan market by making the most of its extensive sales network and thousands of millions of customers."[31] Continuing corruption scandals within CCB[32] have likely delayed or scuttled negotiations between Citibank and CCB, but given the fact that HSBC owns 19.9% of China's Bank of Communications, Citi will pursue entry into state-owned banks at some time in the future to close the gap with its rivals.

Citibank has also entered the market for China's non-performing loans. In December of 2004, Citibank purchased a 227.6 million yuan share of non-performing loans from Silver Grant International Industries, a Hong Kong -listed distressed asset specialist. Silver Grant is one of the four asset management companies (AMCs) created by the Chinese government in the late 1990s to manage $169 billion in NPLs from Chinese banks. The *South China Morning Post* writes that, "The deal paved the way for future sales in an agreement between Silver Grant and Citibank that gives each other right of first refusal to buy their interests in the debt portfolio in the event of any disposals. It

[30] China Business Daily, "Citigroup Unveils Bold New China Plan." March 1, 2004. Accessed at http://www.chinadaily.com.cn/english/doc/2004-03/01/content_310655.htm.
[31] SinoCast China Financial Watch wire report, October 28, 2004. "Citigroup to Move on Construction Bank."
[32] "China Corruption Bank." *The Economist*, March 19th-25th, 2005. Page 79.

was a swift sale by Silver Grant, which bought the portfolio from China Cinda in September for 1.5 per cent of its face value before selling it to Citibank at two cents on the dollar."[33] If Citibank can recover a small percentage of these NPLs, their minimal investment will produce big returns and enhance its status as a premier corporate bank on the Chinese mainland.

Citibank is also looking to diversify its operations in China by entering the insurance market. *China Daily* reported in May 2004 that Citibank was expected to launch a joint-venture insurance company in Shanghai in early 2005. According to *China Daily*, the China Insurance Regulatory Commission (CIRC) granted permission last year for the Travelers Insurance Company, a subsidiary of Citigroup, and Shanghai Alliance Investment Ltd to launch a 50/50 joint venture life insurance firm. Chinese law permits foreign insurance firms to launch joint-venture insurance companies as long as the foreign firm's interest does not exceed 50%. This regulation was altered in January 2005 to eliminate geographic restrictions for foreign insurance firms, but it is difficult to determine whether the changes have been merely cosmetic. While insurance is not a lucrative market in China at this time, it is expected to become much more profitable as living standards and incomes rise.

Recommendations

Citibank started out its re-entry into the Chinese market by attempting to leverage its power as a global bank to force its way to the top. That strategy obviously did not work as it had planned, and Citibank has changed its operations to reflect a more local viewpoint. While it may seem a logical choice to switch strategies if they're not

[33] Denise Tsang. "Citigroup buys first NPLs off Silver Grant." *The South China Morning Post*, December 13, 2004. Business Section, Page 1.

working, Citigroup should still attempt to use its global brand to build its name in China. To wit, here are several recommendations for how Citigroup should move forward in China.

1) **Buy into one of the Big Four State-Owned Banks**- As mentioned above, Citigroup has apparently been in talks with the Construction Bank of China to buy a stake of its business. The corruption issues with that bank have most likely put a hold on any further negotiations by CBC, and for good reason. Citigroup's own recent troubles with regulators in the United States and the European Union have given the bank enough of a black eye; involvement with a Chinese corruption scandal would be unnecessary. At the same time, the system that each state-owned bank controls is very attractive to foreign banks looking to increase their presence in China. Citigroup should approach the other three state-owned banks to buy into their system. While the bank already owns a piece of SPDB, and has started strongly with its credit card business, the advantages of the state-owned bank system over a bank like SPDB are unmistakable. If Citigroup does not buy into these banks, its competitors will and will be able to secure market share for the foreseeable future.
2) **Continue to establish joint-ventures, but plan for independent operations-** Citigroup was right to be wary of joint ventures during the early days of its reintroduction to China. There are definite risks of theft, corruption and intellectual property disputes when doing business in China, and the cost of upgrading segments of the Chinese sector to Western standards can be daunting. For the time being, however, regulatory issues have prevented foreign banks from

operating as they would like in the country. Citigroup should continue to build partnerships with local firms with the expertise to operate in the country, but should prepare for the time when it will be able to operate independently in China. The bank must understand that each of its partners wants to be a competitor of Citigroup's in a short period of time and cannot become too attached to the idea of partnering when it does not make sense in the long-term.

3) **Approach the purchase of NPLs with great care-** While Citigroup has decided to make an entry into the NPL market with its purchase of assets from Silver Grant International, the company must approach any further purchases with extreme caution. There is little information available concerning the recoverability of these loans, and while the company may view this purchase as an experiment, it should refrain from making any further purchases without expanding its lineup of services in China first. There are likely to be more profitable and less risky ways of doing business in China than the market for NPLs.

4) **Continue its lobbying of the Chinese government for a loosening of regulation-** One of Citigroup's competitive advantages is its close relationship with the governments of the countries in which it does business. As mentioned previously, the company is seen as being a true local partner in many instances rather than appearing as a foreign raider. Citigroup must leverage its reputation in China to lobby government officials to remove the restrictions on foreign banks on-time and in-full. Perhaps its initial purchase of NPLs was a part of this strategy; the bank may view its investment as a show of good faith to the Chinese

government. If so, the company should seek other ways to influence the government, which will enable Citigroup to expand as quickly as it would like.

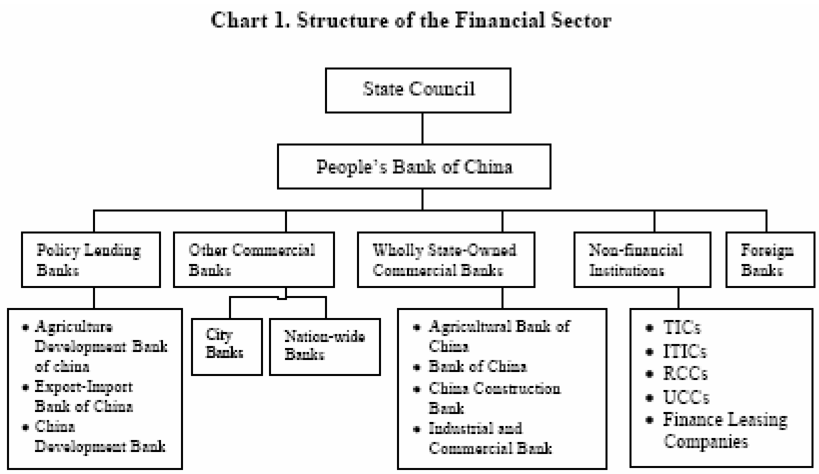
5) **Expand its service offerings, but do not overextend-** The idea of expanding the services that Citigroup offers in China is excellent, but there are several problems with expanding too quickly. First, the current services aren't necessarily profitable yet and it is important to ensure their profitability before moving on to others. Second, the Chinese regulatory environment is such that stepping into entirely new businesses could challenge existing laws and make further expansion more difficult. Finally, the market is still developing in China and it is somewhat difficult to determine which businesses will be profitable and which will not. For these reasons, Citigroup should explore new services and business segments, but should solidify its current services without expanding too quickly for fear of overextension.

6) **Consider offering to serve rural areas in exchange for greater freedom throughout the country-** The majority of growth in all sectors of the Chinese economy is taking place on the eastern coast; for good reason, since that is where the largest, most highly populated and wealthy citizens live. As a result, large swaths of China are missing the development boom altogether, or not reaping the full benefits of China's tremendous economic growth. Banking is no exception to this rule. If Citigroup is interested in relaxing the government regulations on its operations, perhaps it could offer to expand into the western sections of the country as well as serve the wealthy eastern coast. These towns and villages are being ignored by foreign banks, and if Citibank would offer to extend its business

to these regions, the Chinese government may be more willing to allow Citibank to expand more quickly. The Chinese government would see increased development in these poorer areas, and Citigroup could get increased access to the market in return.

7) **Send its most promising employees abroad for educational programs-** If Citigroup wishes to continue its reputation as a "local" bank, it must hire Chinese nationals to staff its operations in China. It is likely that these employees are unfamiliar with western banking practices and disdainful of corporate governance standards. In order to ensure the highest quality workforce for its Chinese operations, Citigroup should identify its most promising Chinese employees and send them to Western business schools to indoctrinate them in Western business practices. By doing this, Citigroup may be able to avoid corruption scandals that have engulfed China Construction Bank, and improve performance at the same time.

Exhibit 1



Source: Banks' Lending Behavior and Firms' Corporate Financing Pattern in the People's Republic of China

Exhibit 2

Banking and insurance permitted business for WTO

	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06
Banking						
Open cities	Shanghai, Shenzhen, Tianjin, Dalian	Guangzhou, Qingdao, Nanjing, Wuhan	Jinan, Fuzhou, Chengdu, Chongqing	Kunming, Zhuhai, Beijing, Xiamen	Shantou, Ningbo, Shenyang, Xian,	All
Permitted business	Foreign currency business; renminbi business with foreign-invested enterprises		Renminbi business with domestic firms			Renminbi business with local individuals
Minority investments	Single foreign ownership limited to 15% of equity					Ceiling raised to 20%
Insurance						
Open cities	Shanghai, Guangzhou, Dalian, Shenzhen, Foshan		Beijing , Chengdu, Chongqing, Fuzhou, Ningbo, Shenyang, Suzhou, Tianjin, Wuhan, Xiamen	All		
Permitted business						
Life	Individual foreign and local			Group foreign and local		
Non-life	"Master policy" insurance and large commercial risks nationwide; foreign-invested enterprises		Domestic enterprises			
Broking	Large-scale commercial risks, for reinsurance and for international marine, aviation and transport insurance					
Ownership						
Life	Joint venture with 50% ownership					
Non-life	Branch or joint venture with 51% ownership		Wholly-owned subsidiaries			
Broking	Joint venture with 50% ownership		Joint venture with 51% ownership		Wholly-owned subsidiaries	
Minority investments	Total foreign investment to be less than 25% of equity					
Reinsurance restriction	All insurance companies must reinsure 20% of business with a domestic reinsurer		Minimum falls to 15%		5%	

Source: Economist Intelligence Unit, Goldman Sachs

Exhibit 3

Details Regarding Chinese Asset Management Companies

(In Hundreds of Millions of RMB)

AMC	Cinda	Huarong	Great Wall	Orient	Total
Established	April 1999	October 1999	October 1999	October 1999	
Related Bank	China Construction Bank	Industrial and Commercial Bank of China	Agricultural Bank of China	Bank of China	
NPLs removed	3,730	4,077	3,458	2,674	13,939
Capital	100	100	100	100	400
Central Bank Lending	0	947	3,450	1,074	5,479

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