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BACHELOR THESIS IN FINANCE

The Impact of Regulations on Foreign Banks in China

- A Case Study on Citi's Banking Business in China

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ABSTRACT

This paper aims to study the impact of the relaxation in regulations on foreign banks in China; based on the case of Citi. In our analysis we discuss the opportunities created for Citi as regulations were changed and the attractiveness of different entry approaches that Citi has undertaken. We found in our study that the relaxation of the regulations has offered foreign banks new possibilities; however, the poor implementation of the regulations has formed the actual barrier for foreign bank entries.

Keywords: China's banking sector, regulations, the WTO, foreign banks, Citi, domestic banks, acquisitions

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1. INTRODUCTION

For many decades, China had a planned economy and was closed for foreign companies. The opening of the country in 1978 was a huge step for China, and a great opportunity for foreign investors. Growth potential was found in every sector of the Chinese market and an increasing amount of international companies sought their way to China to establish their businesses. One of the most attractive markets was the banking sector (Allen, 2005). The yet unexplored and under-developed industry enclosed plenty of opportunities. Operation inefficiency and the lack of competent governance resulted in a poor performing market (Cho, 2001). However, the opening of the market did not mean that foreign banks could operate freely in China. Strict regulations were imposed on foreign investors in order to protect the domestic market and domestic players. Studies have suggested that China's defensive governance was needed to protect weak domestic players in the competition with strong foreign players (Stiglitz, 1993). Many studies have focused on the inefficiency of the Chinese banking sector and identified possibilities and advantages that foreign players might bring to China. *He* (2004) argued that foreign companies bring more competition to the Chinese market, which in turn enhance managerial and operational efficiency. Foreign competition put positive pressure on domestic banks (Levine, 1996) However, regulations were protective of the domestic market until the accession to the World Trade Organization (WTO). With the entry, China was obliged to open up the market. The period after the accession to the WTO and during the implementation of the WTO agreement, was critical for foreign bank establishments. As regulations were changing, numerous foreign banks entered the market; both through acquisitions of existing domestic banks and new investments in subsidiaries.

Our study aims to investigate the impact of regulation changes on foreign bank establishments in the Chinese market. New opportunities for foreign banks are to be created as a result of the WTO membership. The opening of the market is newly introduced, leading to many new establishments. Previous studies have reached general conclusions regarding the impact of regulation changes on foreign bank entrance in China and consequences of it; we aim to do a case study on a specific bank; namely Citi[1]. Citi is one of the largest international banks in the world, with operations in more than 160 countries and over 200 million customer accounts. Their presence in China can be traced back to the beginning of the 20th century and they have been one of the first global banks active in China. Thus, Citi has been able to observe the

[1] Citi refers to Citibank, which is the commercial banking subsidiary of Citigroup Inc.

development of the Chinese banking sector. This case study will look at how regulations have affected Citi's establishments in China and what impact Citi has had on the domestic market. The question to be answered in this study is: *How has the relaxation of regulations affected Citi's establishment in the Chinese banking sector?*

2. PREVIOUS STUDIES

This section will briefly describe relevant studies made in the field of foreign banks' entry to developing markets and specifically in China.

Earlier studies about the field of foreign banks' establishment and regulations have had a broad scope. *Stiglitz* (1993) discussed several reasons behind why there should be restrictions imposed on foreign banks in domestic markets. Among the reasons is that foreign banks have more experience. The importance of know-how in the banking business creates disadvantages for domestic banks in developing countries, since investors might have more confidence in experienced foreign banks. Thus, domestic banks lose out to foreign competitors. Another reason is that foreign banks and domestic banks compete on different conditions. Foreign banks are less sensitive to governmental pressure and policies, which in turn put domestic banks in an inferior position. The worst case scenario for a foreign bank would be that the local government closes the bank. It is a comparatively insignificant punishment for a foreign bank with an extensive international market, if compared to a domestic bank where it is equivalent to the survival of the bank. These reasons, among others, create unfair prerequisites between foreign and domestic firms, which mean that regulations on foreign banks are necessary.

However, other studies suggest advantages with foreign bank participation. *Levine* (1996) argued that the opening up of the domestic market to foreign entry might encourage financial developments in improved service quality and higher competition, which in turn drive prices on services downwards. Moreover, foreign bank entry might facilitate access to the international capital market, and stimulate the development of financial policy and legal framework, as well as advance practices of banking skills and technology. *Claessens* (2001) also concluded that foreign ownership lead to more competition and operational efficiency in the banking market. Some studies are made specifically about the Chinese market. *Cho* (2001) discussed the need of foreign bank participation in China due to the many challenges China is facing, such as bad performing asset and loans. *Leung* (2011) recently did a study on foreign banks' impact on the Chinese banking market and concluded that foreign banks enhanced stability and encouraged competition.

With China's accession to WTO, many studies are done with focus on the increased foreign establishments in China. *Leigh & Podpiera* (2006) found that, in contrast to other countries where most foreign bank entry occurred via direct takeover or majority shareholding, foreign bank entry in China has been in the form of minority shareholding. *He* (2004) also made a study on foreign bank entry in China and recognized the acquisition of domestic banks as the most common strategy. Acquisition facilitates expansion since Chinese banks usually have a geographical significance or a certain degree of national coverage. Furthermore, foreign banks benefit from an extended supplement of business network, market information and public relations that domestic banks possess. In turn, foreign banks facilitate the collaboration between China and the world, increase the competition and enhance the development of the Chinese banking sector. A study done by *Claeys & Hainz* (2006) further discussed the advantages of acquisition in comparison to Greenfield investments. The study suggests that through acquisition, the foreign banks can obtain soft information, which is not available in Greenfield investments. The soft information mentioned in the study refers to non-verifiable data, for example in the form of knowledge about the local market and relationships to customers, competitors, as well as the government.

Previous studies have focused on why China should open up for foreign bank entries and what entry mode to use. The studies are based on broad observations and therefore, yield a general conclusion. However, we have not seen any study on a specific case, and therefore we find it interesting to study a specific foreign bank operating in China to verify the applicability of the conclusions previous made.

3. METHODOLOGY

In this section we will explain the methodology used and the scope of the paper.

The scope of the question is adjusted to limitations. Foreign banks are defined as the Chinese regulatory framework, i.e. wholly foreign-funded banks, Chinese-foreign joint venture banks, branches or representative offices of foreign banks. The scope of the study will focus on the Chinese banking sector and limited to the market in Mainland China (that is, not including the special administrative regions Hong Kong and Macau, as well as Taiwan). The study is constructed as an event study with the accession to the WTO as the event. The time frame will surround China's accession to the WTO, and compare the regulatory framework prior to and after the entry. We will just look at the regulations affecting foreign banks' establishment in Mainland China and specifically only those regulations that have changed. Furthermore, we will constrain the study to Citi's main actions in their establishment in Mainland China, and limit to only focus on Citi's commercial bank investments in China. The study will not go beyond the scope of Citi's banking business or go into detail regarding the different service areas. Instead this study will examine the entry opportunities created for Citi with the new regulations.

The study will begin with an introduction to a theory which will be used to evaluate the different entry modes that Citi faces. Afterwards, a brief background over China's banking sector and history of the foreign bank presence in China will be presented, following with a presentation over the regulations affecting the choice of entry mode of Citi. The background information and regulations are based on academic articles, publications and relevant regulatory documents. Thereafter, the case of Citi will be presented. A background of Citi and its establishments are presented. In order to look at Citi's expansion in China, we have decided to look at two domestic banks which Citi has stake within; namely Shanghai Pudong Development Bank and China Guangfa Bank. The case study of Citi will focus on Citi's expansion in China through these two banks. The information of the case was chosen to be based on their official websites, annual reports and news releases. The reason for not conducting a qualitative study with interviews with representatives from Citi was mainly to avoid biased views of the firm's activities. Furthermore, through a varied information compilation we believe our study covers a broad view of Citi's establishment in China.

The analysis will be approached in a chronological order, as regulations changes and new opportunities are created. Attention will be on aspects that previous studies have focused on, in order to find parallels between our case and the general conclusions. The case of Citi will be analyzed based on the modifications made in the Chinese regulatory framework in relation to Citi's entry strategies. Although the study will be focusing on a single firm, this approach will attempt to explain a wider and more complex occurrence.

4. THEORETICAL FRAMEWORK

In this section, the real option theory, to which the case study will be connected, will be described in detail.

In Berk and DeMarzo (2011), the *real option theory* is presented. The theory is used in the decision-making process of business investments. Traditionally an investment is valued, and decision made, by taking the expected return or net present value (NPV) into consideration. Real options are alternatives or choices that arise with investment opportunities when specific conditions ascend or new information becomes available. These options create value to the evaluation of investments. The valuation of potential investments can be affected significantly if taking real options into account. Two common real options that we will discuss in our paper are: the option to grow and the option to abandon a project.

Some project opportunities are only created if previous investments are made. When such a condition is met, the firm has a real option to grow. A company that applies a project on a small scale in the beginning, and gets the opportunity to increase the investment in the future, has a growth option. The advantage of taking investment in stages is that it allows the firm to postpone its investment until they have sufficient and relevant information to justify a larger investment.

When a project proves to be unsuccessful, the firm has the possibility to mitigate its loss by abandoning the project. That is, the option to abandon an investment. It is easy to ignore the value of abandonment. In many cases the killing of an unproductive project can add more value than continuing with it, and then the option to abandon the project is valuable.

The real options allow a decision-maker to choose the most appropriate alternative based on the value added through the real option. In environments characterized by high uncertainty, this value can be of substantial impact. As a result, the value of these options must be taken into account in the decision-making process in order to make the most accurate investment decisions.

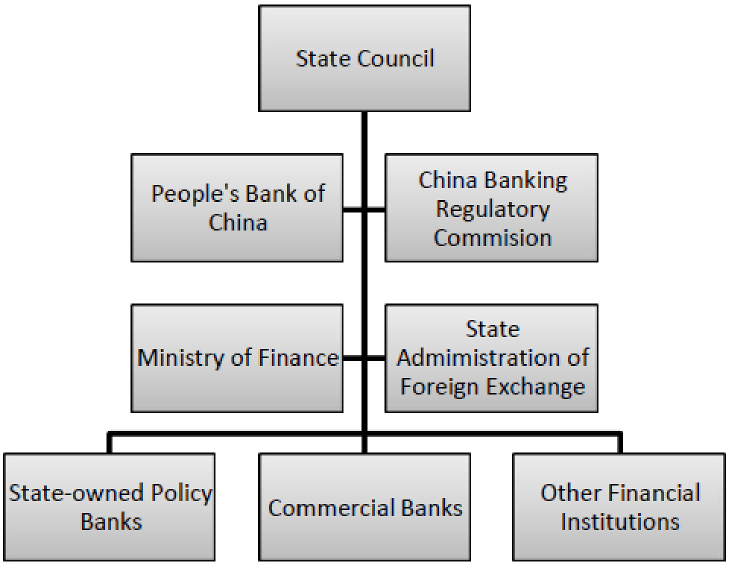
5. INDUSTRY OVERVIEW: CHINA'S BANKING SECTOR

This section will provide the background information regarding the banking industry in China, in order to give the reader a better overview of the industry that is brought up in the paper. First the market will be presented, followed by a description of the regulations before and after the accession to the WTO.

China's banking sector of today has four regulatory entities reporting to the State Council. Each of the four entities has distinct responsibilities. The People's Bank of China (PBOC) serves as the central bank of China, with the main responsibility of formulating and implementing China's monetary policy. The PBOC sets reserve standards for banks, decides interest rate for intra-bank lending and controls the money supply. The China Banking Regulatory Commission (CBRC) is responsible for the regulation of banks in China and ensuring that the banks follow laws and regulations, and to protect interests of depositors and customers. The Ministry of Finance (MoF) was once the sole authority for China's financial sector, with the PBOC and state-owned banks reporting to them. Today the MoF's responsibilities have been reduced to only being responsible for China's fiscal policy and the central government's budget. Even though the MoF is not directly supervising any state-owned banks anymore, it possesses large stakes of equity holdings of many previously state-owned banks. The State Administration of Foreign Exchange (SAFE) reports both to the State Council and the PBOC. Their main responsibilities are supervising and monitoring foreign exchange transactions in China and the management of the government's foreign exchange reserves. The SAFE is also responsible for the regulations of "qualified foreign institutional investors" – QFIIs. Non-Chinese organizations have to be QFII's in order to purchase stocks, bonds and other financial assets in China. Regulation states that the QFII's must have an authorized Chinese custodian bank as a partner (Martin, 2012).

In figure 1, on overview of China's banking sector is presented.

Figure 1. China's banking sector overview



Source: Based on Martin (2012), "China's Banking System: Issues for Congress"

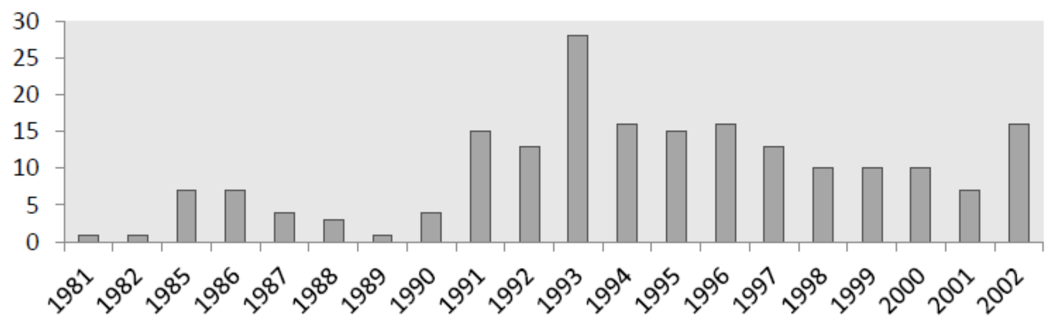
5.1 The Evolution of the Chinese Banking System

China had a planned economy until the country decided to reform the economic system, including the banking sector, in 1978. Before, the economy and production were largely controlled by the state. Few private entities existed and little emphasis was put on competition and profitability. However, to ensure economic growth and be able to compete in the global market, the government – with the lead of Deng Xiaoping – decided to open up the Chinese economy. The main changes focused on production, but decentralization of several economic sectors were also on topic. The reformation encouraged the change of the banking and financial sector to behave more competitive. Going from an isolated and government-controlled banking sector, the reform aimed to turn the banking sector to become a more competitive and autonomous market (Martin, 2012).

To enhance competition, the reform allowed the entry of foreign banks to the domestic market. Historically, foreign banks served as international trade portals between China and the outside world. After the 1930s, a period of turbulence and crisis hit China. Civil war and hyperinflation in the 1940s resulted in a change in the banking structure. Although the crisis was not related to foreign banks, the government established a fully state-owned banking structure, resulting in strict regulations on foreign exchange markets. After the Second World War, the foreign exchange market was strictly controlled by the government and no foreign banks were allowed to operate in the Chinese market. During the absence of foreign banks, the banking sector was nationalized, the commercial and financial activities were reduced and focus was set on inward economic development. Not until the reform of China in 1978, the foreign banks made their official re-entry to the Chinese banking market.

Since the re-opening of the Chinese banking sector, a number of foreign banks entered the Chinese market through the establishment of new branches. Services provided by foreign branches were highly limited and strictly regulated. In graph 1, the numbers of new branches approved each year are shown during the period of 1981 to 2002.

Graph 1. Numbers of new foreign bank branches approved, 1981-2002



Source: Based on He (2004), "Foreign banks in China: What impact would they bring about"

5.2 Problems Facing the Chinese Banking Sector

The Chinese banking sector is threatened by instability and several severe inefficiency factors. One of the major threats to the Chinese banking sector is the amount of non-performing loans (NPL). NPL refer to loans which are defaulted or close to default. Vague definition, lousy inspections on debt-takers and lack of transparency in China's banking system are the main causes for the problem of NPL to be significant. There were percentage restrictions on the amount of loans allowed to be classified as non-performing. For instance, no more than 2% of all loans could be classified as "bad debts". Combining weak data together with judgment bias, the NPL problem became worse. In 1995, China formally introduced a loan classification system. The NPL classification got three tiers; "past due loans" if loans were not repaid in due or after the extended due date; "doubtful loans" that had past due date with two years or more;

and “bad debts” which are loans debtors having declared bankrupt. This loan classification system was still seen as unclear in definition, leading to different interpretation of the amount of NPL in China. Between 1992 and 1997, the NPL ratio increased from 20% the two first years to 30% in the following years (Wu, 2002).

In the end of 2003, China decided to reform the loan classification system to follow the international standard. The five-tier loan classification system was announced and would come to effect in 2004 (Hong Kong Trade and Development Council, 2003). Loans are now classified as pass, special-mentioned, sub-standard, doubtful and loss. The ranking is based on the client’s state of operation and loan quality, the ability and possibility to repay loans. If debt-takers ability and possibility to repay loans is questioned, it is classified as “substandard”. When the borrower cannot repay the loans and significant losses are expected, the loan is classified as “doubtful”. “Loss” indicates loans that cannot be recovered or only small amount can be recovered. Additionally, “special mentioned” are loans that the repayment ability might be affected by factors such as business losses. With stricter loan classification, China hopes to lower the amount of NPL. NPL ratios for Chinese banks between 2003 and 2010 are presented in table 1 below.

Table 1. Non-performing loan ratio (%), 2003-2009

	2003	2004	2005	2006	2007	2008	2009	2010
Chinese banks	17.9	13.2	8.9	7.5	6.7	2.5	1.6	2.4

Source: Based on CBRC Annual report (2010) and Leung (2011), "Accessing the Effectiveness of Liberalization Policies for Foreign Banks in Post-WTO China"

Moreover, Chinese banks suffer from weak asset quality. Recapitalization and injection of new capital into Chinese banks are made in order to increase capital and strengthen the capital adequacy ratio (CAR[2]). A regulatory requirement of CAR is set to 8%. Apart from high amount of NPL and bad asset quality, Chinese banks also suffer from poor corporate governance and internal controls, and lack of risk management skills.

5.3 Entrance to the World Trade Organization

China entered the World Trade Organization (WTO) in November 2001 and became an official member in December the same year. The WTO is a forum for trade negotiations and

[2] Capital adequacy ratio is a measure of a bank’s capital to its risk-weighted assets.

agreements. The organization advocates trade opening and resolve trade problems between governments. The WTO aims to open up markets and lowering trade barriers such as tariffs and other restrictions; increase competition and fair treatment for foreign and domestic players; and increase transparency and predictability.

One of the main purposes with the WTO accession was to promote the competition from external sources in China and thus further stimulate the economy. The many problems, such as the amount of NPLs and bad corporate governance, which exist in the Chinese banking system are anticipated to be dealt with. As a part of the agreement with the WTO, China had to agree to open up its financial market. This would take place over a period of five years and meant that competition would be allowed from foreign actors. The regulative authorities in China have emphasized the objective to gradually treat foreign banks no different from domestic banks. In 2003, the China Banking Regulatory Commission (CBRC) was founded in order to regulate the banks in the financial sector in China. The main purpose was to regulate the banking sector, strengthening the regulatory institutions and making regulations more effective. The opening up of the Chinese banking sector is based on four principles; to meet the ongoing needs of domestic economic development; to improve overall competitiveness of the Chinese banking sector; to honor the commitments to the WTO and create an environment for fair competition between Chinese and foreign banks; and to maintain China's financial stability. Instantly after the announcement of the WTO entry, the PBOC published the relaxed regulations for foreign banks in China. These will be further brought up in the following segments.

5.3.1 Regulations of Equity Investment in Chinese Banks by Foreign Banks

The "Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions" came into effect on December 31, 2003, following the approval of the State Council. These rules would regulate the activities surrounding equity investment by overseas financial institutions in Chinese financial institutions. Foreign banks have to meet certain requirements in order to invest in Chinese banks. These are regulated in article 7 (See appendix 1 for details). Among the criteria, the total assets of the foreign bank should sum up to at least US$10 billion the year before the investment; the foreign bank has to show profit in the two last consecutive years; and the CAR shall not be below 8%. The acquirer is also expected to have sound internal controls. Although these requirements are met, foreign investors still face restrictions in the scope of the investments. In article 8, the equity investment of a sole foreign investor is regulated. The investment of the same foreign entity should not be more than 20%. Moreover, in article 9, it states that the total overseas investment in a non-listed Chinese-funded financial institution shall not exceed 25%; otherwise the financial institution will be treated as a foreign-funded institution (See appendix 1 for details).

5.3.2 Regulations of Foreign-funded Banks

Foreign banks that wanted to enter the Chinese market in the 1980s (closely after the opening up of the Chinese economy) were subject to strict regulatory framework. "The Regulations for the Administration of Foreign Banks and Chinese-Foreign Joint Banks in the Special Economic Zones" became effective in 1985 and restricted the geographical scope of foreign banks. Foreign banks could only operate in branch form or as a Chinese-foreign joint bank. These were restricted to only operate in special economic zones with other foreign investors, where the market was more free-market oriented and located in coastal areas. The scope of services provided were also restricted and had be granted by PBOC (See appendix 2 for details).

These regulations were later replaced by "The Regulations of the People's Republic of China on Administration of Foreign-funded Banks" in 1994. The scope of services allowed was extended, and foreign banks could provide services in foreign currencies. However, domestic currency business was still very restricted and the foreign banks had to get the approval from the PBOC in order to engage in selected businesses (See appendix 3 for details).

The 1994 regulations were later revised twice, in 2002 and 2006. The latest revision became effective as of December 11, 2006, in accordance to the five year time frame of fully open up China for foreign banks. With the 2002 regulations, restrictions on foreign banks and foreign branches were relaxed. For instance, they were allowed to engage in RMB business, handle deposits from Chinese local residents and conduct a credit card business. However, the geographical scope which foreign banks could engage in domestic currency business was still restricted. High requirements, such as prior experience in operation in the Chinese territory and profitability, marked as entry barriers for foreign banks to conduct RMB business.

Furthermore, as earlier regulations, the decision whether they were actually allowed to conduct the business was still a matter to be decided by PBOC (See appendix 4 for details).

The revision in 2006 further expanded the scope of services allowed for foreign banks. The relaxation of regulations gave foreign banks even more possibilities to engage in foreign exchange and RMB business (See appendix 5 for details). The revised regulations presented four definitions of foreign-funded financial institutions:

"(1) A wholly foreign-funded bank funded solely by a foreign bank or jointly with any other foreign financial institution;

(2) A Chinese-foreign joint venture bank jointly funded by a foreign financial institution with a Chinese company or enterprise;

(3) A branch of a foreign bank; or

(4) A representative office of a foreign bank"

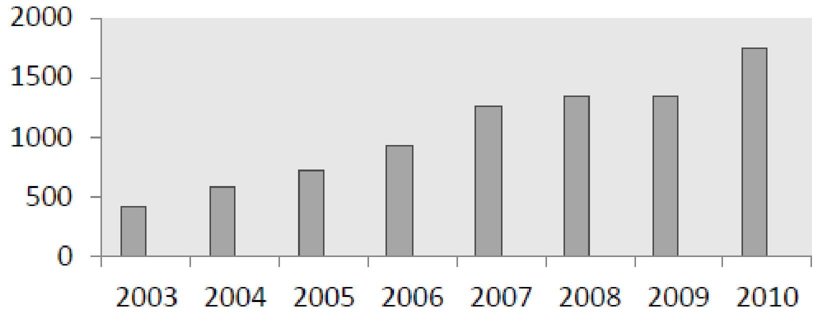
In sum, the basic stipulations have been revised in three areas since the WTO-entry. First of all, geographical restrictions on foreign banks were abandoned. Instead of only be able to operate in certain "Special Economic Zones", foreign banks were allowed to enter China's inland regions and hold stakes in Chinese banks to form new partnerships. Secondly, the foreign banks were no longer restricted to only engage in businesses in foreign currency, but also Chinese RMB denominated banking businesses. Thirdly, the foreign banks were allowed to engage in banking businesses with Chinese clients, both firms and local residents.

5.4 Developments in the Chinese Banking Sector

Besides relaxed regulations providing foreign banks greater access to the Chinese banking market, several previous privileges offered to foreign banks were eliminated. To create a platform of fair competition and let foreign banks operate on same conditions as Chinese banks, privileges as tax holidays and reductions were removed. However, the United State Trade Representative (USTR) still reckon that China has not fully fulfilled their WTO agreement to open up the Chinese banking sector for foreign competition.

In 2011, the USTR sent a report to Congress regarding China's WTO compliance. In the report, USTR brought up the short comes of the compliance. In the agreement with WTO, China was obliged to open up the domestic currency market to foreign banks with no restrictions. There should also not be any geographical limitations. China has in line with WTO opened the market for foreign banks and permitted foreign banks to conduct RMB business, but the requirements set on foreign banks were far higher than international standards. For instance, high working capital requirement, prior experience and profitability requirements were imposed on foreign bank, limiting foreign bank participation in the Chinese market. A report by KPMG (2007) stated that CBRC will only allow incorporated banks to conduct RMB business, to provide greater protection of customers. The USTR report further claimed that the problematic factor of the limitation in RMB business is because foreign banks are most eager to engage in this business. Despite restrictions, many foreign banks have chosen to start banking businesses in China. In graph 2, total asset of foreign banks in China have been compiled for the period 2003-2010.

Graph 2. Total asset of foreign banks, 2003-2010 (billion, RMB)



Source: Based on CBRC Annual Report (2010)

Another issue that USTR argued to have not been fully implemented was regarding the limitations of ownership of Chinese-foreign joint-stock banks (See section 5.3.1 for details). Limited stake ownership of foreign banks restricts foreign bank activities, which was not in line with the WTO agreement. Other members of the WTO have urged China to ease the restrictions for several years without progress. Apart from the USTR that has expressed their dissatisfaction with China's compliance to the WTO, it has been reported that 26 disputes are filed on China. China has refused to act on foreign investors' applications of issuance of credit cards in RMB. Negotiations during 2007 and 2008 between China and the US, finally reached an agreement to grant foreign applicants of credit card issuance right to operate in China. However, China required the data processing for these credit and debit cards to stay within China, which is a costly process for foreign banks. Further negotiations between the US and China have taken place, resulting in relaxed implementations on foreign banks. In the report, USTR also stated that U.S.A "will make every effort to ensure that China fully implements its WTO commitments".

6. THE CASE OF CITI

The specific case of Citi will be brought up in this section: how the American bank has increased its presence in China and the details about its acquisitions in the two Chinese banks, Shanghai Pudong Development Bank and China Guangfa Bank.

Citi is one of the leading banks in the world. According to Global Finance (2011), Citi is one of the 10 biggest global banks based on total asset, amounting US$1914 billion. In 2010, Citi announced a profit of US$10.6 billion in its annual report, generating a return on equity of 6.8%. Citi offers a wide range of financial products and services to consumers, corporations, governments and institutions. With a strong capital base (capital adequacy ratio reached 16.99% in 2011, exceeding the minimum requirement of 8% and the well capitalized minimum of 10%), transparency and responsibility taking into their business conduct, Citi aim to expand further globally. Operating in over 160 countries and more than 1000 cities, Citi has the ambition to bring financial solutions to customers all over the world. One of the countries that Citi has set as expansion target is the People's Republic of China.

With its red, white and blue American flag, Citi is known as Hua Qi Yin Hang (Flower Flag Bank) in Chinese minds. Citi's first office in China opened in 1902 in Shanghai. However, it was not until 1983 that Citi started to focus on the Chinese market, beginning with its representative office opened in Shenzhen. In the following years Citi has further expanded their regional coverage through the opening of more representative offices and branches in major cities such as Shanghai and Beijing. Since then, Citi has been the first international bank to conduct various banking services. In 1998 Citi became the first international bank in China that offered nationwide Renminbi (RMB) cash management. Citi was also the first international bank to open a retail banking business and be granted to offer foreign currency investment products to Chinese consumers and to launch co-branded dual currency credit card. In 2007, Citi established a wholly foreign-funded subsidiary in China, named Citibank (China)

Co., Ltd (Citibank China). Citibank China was among one of the first foreign banks to locally incorporate in China. Today Citibank China is a leading bank in China and has thirteen corporate bank branches, two investment bank representative offices and 47 consumer bank outlets around the country.

Citi is at the leading-edge of international banks in China and hope to double the number of branches in China. In an interview with Financial Times (2012), the chief executive of Asia for Citi, Stephen Bird said: “In two-three years we will pass 100 branches in mainland China from 47 today.” He also mentioned that Citi has been profiting from helping Chinese institutions in product and technology development. The belief is that the long-term projects helps Citi’s standing in China.

Citi has stakes in two domestic banks in China; Shanghai Pudong Development Bank and China Guangfa Bank. According to Jan Stjernström, Head of the Life division for SEB (previously at Citigroup), the method of acquisition has historically been of limited use in emerging markets by international banks due to local restrictions on ownership. Many global banks prefer entering a market by the set-up of wholly-owned subsidiaries. A possible reason could be that international banks have established unique business models and cultures. To enter a market via a fully-owned subsidiary, and recruiting local people that possess the necessary knowledge about the domestic market, is often seen as a less risky approach. However, regulations on foreign participation are common strategies that developing countries use in order to protect and develop the domestic market (Stjernström, 2012). Thus, Citi have chosen to use the strategy of acquiring domestic banks in China. Citi and its relationship with its Chinese bank partners, Shanghai Pudong Development Bank and China Guangfa Bank, will be presented below.

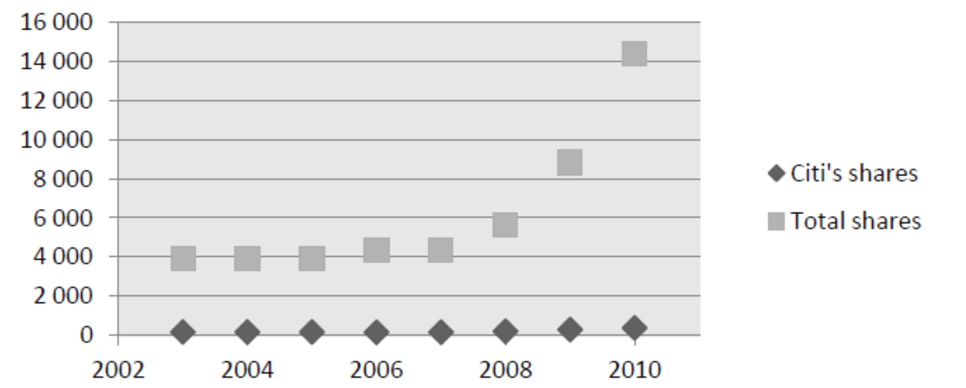
6.1 Shanghai Pudong Development Bank

Shanghai Pudong Development Bank Co., Ltd (SPDB) was approved by the PBOC and incorporated in 1992. SPDB is a joint-stock commercial bank, and implied by its name based in Shanghai. It is registered on the Shanghai Stock Exchange with the stock code 600000. The purpose of the formation of the SPDB was to provide financial services for the development of Pudong, one of the most affluent areas of Shanghai.

According to Citi's website, the American bank entered into strategic alliance with SPDB in 2002. On December 31, 2002, SPDB signed agreements on strategic cooperation with Citi and received official approval from authorities, which meant the introduction of Citi and its subsidiaries as the Chinese bank's foreign strategic investor. SPDB and Citi would cooperate through exclusive stake holding, credit card businesses, technical support, etc. Additionally, SPDB agreed to allow Citi to be the sole foreign investor, and Citi also accepted to let SPDB to be the exclusive commercial bank in China (not including Hong Kong, Taiwan and Macau). The stake investment made by Citi in SPDB was a long-term strategy in conforming to the Chinese policies and laws. Stephen Long, the CEO of Citigroup International, held a directing and supervising post in SPDB.

In 2003, Citi owned 180.75 million shares in SPDB, which corresponded to a 5% stake of the total share capital in the Chinese bank. SPDB issued another 300 million shares a few days later, resulting in Citi holding 4.62% instead (Howson, 2003). Since the acquisition of SPDB shares, SPDB has done several new issues. In graph 3, Citi's amount of shares in proportion to the total amount of shares is illustrated.

Graph 3. Amount of shares in SPDB, 2003-2010 (million shares)



Source: Based on SPDB Annual Reports (2003-2010)

Citi's stakes in SPDB thru the years 2003 and 2012 are summarized in table 2.

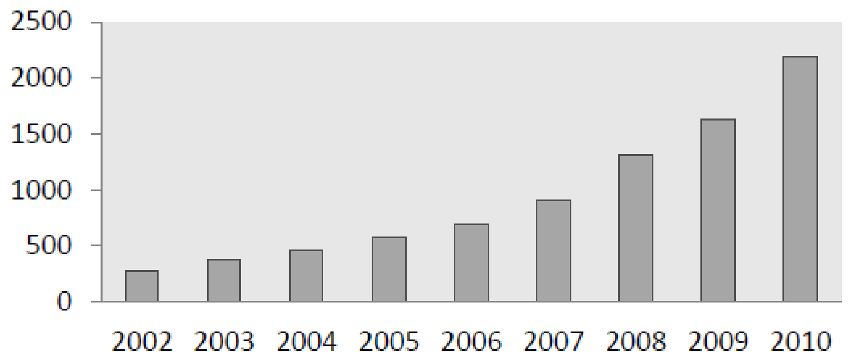
Table 2. Citi's stakes in SPDB, 2003-2012 (%)

	2003	2004	2005	2006	2007
Stake	4.62	4.63	4.64	3.78	3.78
	2008	**2009**	**2010**	**2011**	**2012**
Stake	3.78	3.78	2.71	2.72	2.73

Source: Based on SPDB Annual Reports (2003-2010) and recent press releases

In 2005 there were articles on SPDB considering issuing more shares to make it possible for Citi to increase its stake. As a representative for SPDB told China Daily (2005), the cooperation with Citi was carried on smoothly and the leading U.S. bank planned to increase its stake in SPDB to 19.9%, just below the 20%-threshold. The approval from relevant parties was given in the beginning of 2006. Although Citi only had 4.62% of SPDB stakes, Citi was the fifth largest equity-owner (SPDB Annual report, 2006). SPDB had a very split shareholding, with the largest shareholder owning 7.01% of share. Seven of the ten largest shareholders were state-owned. Together they accounted for 29.21% of the stakes in SPDB in 2006. In graph 4, SPDB's total asset for the period 2002-2010 is summarized.

Graph 4. Total asset of SPDB, 2002-2010 (billion, RMB)



Source: Based on SPDB Annual Reports (2003-2010)

In table 3, some key ratios are summarized for SPDB during the period from 2002 to 2010.

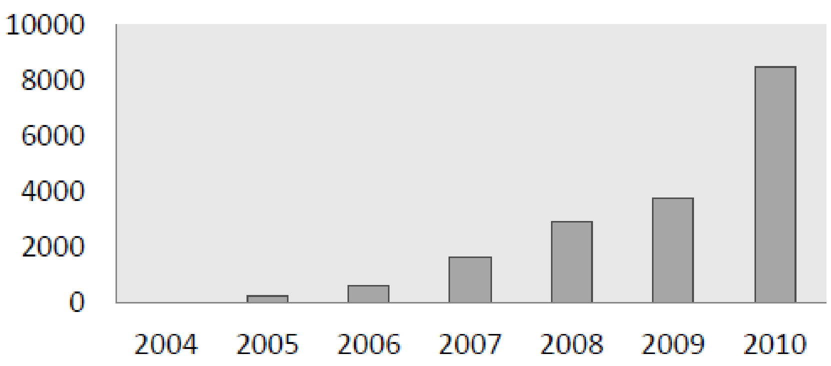
Table 3. NPL ratio and CAR of SPDB, 2002-2010 (%)

	2002	2003	2004	2005	2006
NPL ratio	3.38	1.92	2.45	1.97	1.83
CAR	8.54	8.64	8.03	8.04	9.27
	2007	**2008**	**2009**	**2010**	
NPL ratio	1.46	1.21	0.80	0.51	
CAR	9.15	9.06	10.34	12.02	

Source: Based on SPDB Annual Reports (2003-2010)

In 2004, SPDB and Citi co-launched a dual currency credit card. In graph 5, the total accumulated amounts of credit card issued are shown from year 2004 to 2010.

Graph 5. Accumulated amount of credit cards, 2004-2010 (thousands)



Source: Based on SPDB Annual Reports (2004-2010)

Citi announced on March 19, 2012, in a press release, the successful completion of selling its 2.71% equity stake in SPDB via block trade[3]. The transaction resulted in an after-tax gain of US$349 million (at current exchange rate). The transfer price ended at RMB 8.33 per share, comparable to 90% on the closing price on the day at RMB 9.28 per share (Bloomberg Business Week, 2012).

In February 2012, Citi announced in a press release that its Chinese subsidiary Citibank China was the first Western bank to receive the approval from CBRC to launch an own credit card business in China. A week after announcement, the Chinese Vice President Xi Jinping made an intergovernmental trip to Washington. It is common that approval for deals is made in

[3] A block trade is a transaction that is permissible, noncompetitive, privately negotiated at or exceeding an exchange determined minimum threshold quantity of shares.

connection with these kinds of trips. Earlier, foreign banks have been only allowed to issue credit cards in China in cooperation with local partners (Wall Street Journal, 2012). The launch is expected to be in 2012 and cover both consumer and commercial cards. Taipei Times reported that the co-launched credit card business with SPDB will be taken over by the Chinese counterpart.

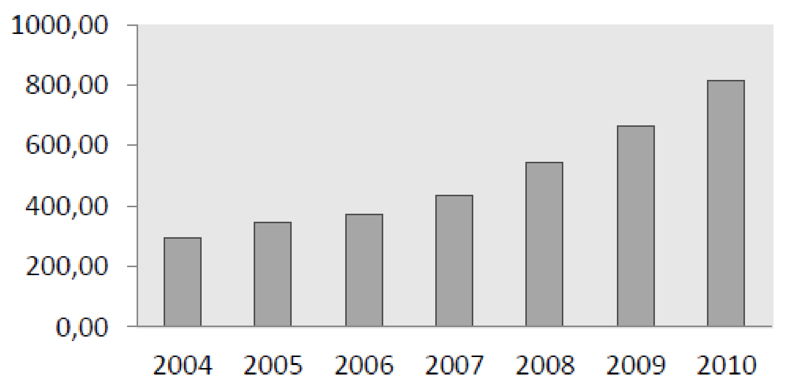
6.2 China Guangfa Bank

China Guangfa Bank (CGB), formerly called Guangdong Development Bank, was founded in 1988. CGB was among the first joint-stock commercial banks approved by the State Council and the PBOC as a piloting bank for the Chinese financial policy reform. For over 20 years, CGB has been the forerunner in new businesses. CGB was first bank to engage in mortgage lending, to launch USD and HKD credit cards, to implement nationwide deposits and withdrawals, etc. However, CGB, as many domestic banks, suffered from weak capitalization, bad corporate governance, high loans, low asset quality and weak profitability. In 2004, CGB was in such a severe condition that they had to receive stimulus from government to reform and restructure the business. A restructuring plan was introduced to turn around the business and transform CGB into a modern commercial bank with the capability to offer high quality financial services enhancing national economic development.

In the end of 2006, CGB was successively restructured. CGB improved the operational management, risk management and capital control with support and advice from the Provincial Government of Guangdong and Citi. Unqualified shareholders, such as governmental or public institutions investors, were removed and qualified domestic and international investors were introduced as strategic investors. On November 16, 2006, 85.6% of CBG was sold to a consortium formed by Citi, IBM and a group of domestic companies, at the price of $3.06 billion (Forbes, 2006). Through that acquisition Citi, purchased 2.28 billion shares, corresponding to 20% of the stake in CGB. The settlement of the acquisition took over a year to complete. The consortium led by Citi eventually beat their rival bidder after a bidding race of 16 months. The New York Times (2006) reported that the delay of agreement was due to Citi’s proposal to buy 40 % of CGB. Citi expected exceptional treatment by the government to let Citi exceed the 20% limit of equity ownership, which the government rejected. The agreement settled with Citi owning 20% stake (maximum line for a single foreign ownership), while IBM (the other foreign investor) would hold 4.74%, keeping the two American companies below the limit of 25% for overall foreign ownership.

Despite holding only 20 % of shares, Citi possesses operational control of CGB. Citi was the second foreign bank to be granted such permission. The only foreign bank given a management control in a Chinese bank previously is the private equity firm, Newbridge Capital, holding 17 % of Shenzhen Development Bank. Right after the acquisition, the former Vice President of Citibank Korea, Michael Zink, was appointed the president of CGB. His successor, appointed in 2010 also had prior experience in Citi as the Country Officer of Taiwan. Citi aimed to enhance CGB's corporate governance, improve risk management and internal controls as well as the operational and lending practices, upgrade the bank's IT infrastructure, and extend its customer service and product offerings. In graph 6, CGB's total assets for the years 2004 to 2010 are presented.

Graph 6. Total asset of CGB, 2006-2010, (billion, RMB)



Source: Based on CGB Annual Reports (2006-2010)

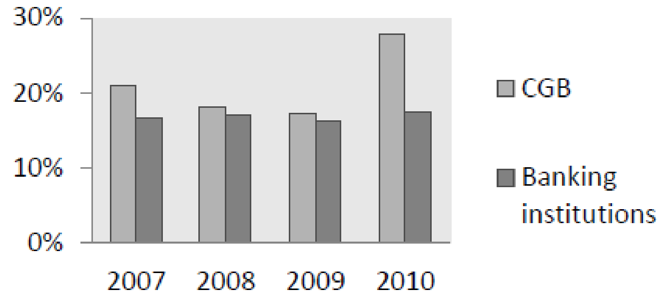
In graph 7, the net profit of CGB through the years 2005 to 2010 is illustrated.

Graph 7. Net profit of CGB, 2005-2010, (billion, RMB)

Source: Based on CGB Annual Reports (2005-2010)

In graph 8, CGB’s return on equity will be put in contrast to the return on equity for all banking institutions in China between 2007 and 2010.

Graph 8. Return on equity of CGB compared to all banking institutions in China, 2007-2010, (%)



Source: Based on CGB Annual Reports (2007-2010) & CBRC Annual Reports (2010)

The NPL-ratios and CAR for CGB between 2004 and 2010 are presented in table 4.

Table 4. NPL ratio and CAR of CGB, 2004-2010 (%)

	2005	**2006**	**2007**	**2008**	**2009**	**2010**
NPL ratio	4.47	5.84	4.00	2.85	2.40	1.58
CAR	(n.a)	6.70	7.14	11.63	8.98	11.02

Source: Based on CGB Annual Reports (2006-2010)

CGB issued new shares in 2009 and 2010. Citi increased the amount of shares in both issues maintaining the 20% stake in CGB. The Wall Street Journal (2012) reported that CGB was preparing for an initial public offering in 2012. By 2010, CGB operated in 29 branches and had a total of 544 outlets, 676 self-service banks and over 3600 self-service facilities in major cities such as Beijing, Shanghai and Nanjing. With the base in the Guangdong province, Citi could via CGB access both the domestic market as well as the adjacent market in Hong Kong. Jim Antos, an analyst at Bear Stearns Asia in Hong Kong, specifically regarded the location of CGB in an interview with the New York Times (2006): "For Citigroup and any foreign bank that has a presence in Hong Kong, that's a very good location. You could leverage off the two economies". A senior economist at Bank of China, Wang Yuanlong, expressed in China Daily (2006) that foreign participation in domestic banks may turn around small unprofitable banks in short period if they have control over it. "Foreign investors are stepping up their investment in China but they are more interested in joint stock banks because they can gain control."

With the increase of overseas investors, nationalists' opposition to foreign control of domestic enterprises also rose. Mark Konyn, the CEO of Allianz Dresdner Asser Management's Hong Kong division, said in New York Times (2006): "We see a fairly cautious approach by the mainland authorities to allow foreign companies to come in and apply best practices".

7. ANALYSIS

In this section, the four distinguished entry modes that have been undertaken by Citi are discussed with regard to attractiveness. The attractiveness is approached with the real option theory and evaluated based on the modifications made in the Chinese regulatory framework and implementation.

Four entities are identified in Citi's establishment in China; representative office, branch, wholly-owned foreign bank and acquisition of domestic bank. The first three entities mentioned are entities owned by Citi, while the last one is an equity investment.

Citi re-entered the Chinese banking market in 1983 with a representative office. Strict regulations both in terms of geographical restrictions and limitations in services that could be provided have excluded foreign competition and Citi's presence in China for many years. Although China was reformed and re-opened for foreign competition, the business scope was highly limited for foreign banks. Foreign banks were only limited to engage in branch banks and within specific regions. That resulted in difficulties for Citi to conduct business in China, which was limited to foreign branches with no local banking business. The necessity to be approved by the PBOC to conduct business in different areas of services led to further limitation in business opportunities. Approved foreign bank branches were very few in the beginning of the re-opening, showing a very cautious approach to foreign participation in general. It was towards 1992 that the number of foreign branches started to increase. The precautious and successive acceptance of foreign establishments composed an uncertain future for foreign banks in China. Even though the regulations were slightly revised in 1994, the scope was still strictly limited to only allowing the conduction of business in foreign currency; reflecting another safe approach from China. The restrictions created by the regulations formed the major barrier for Citi's expansion, resulting in the safe strategy to only establish representative offices and branches, even though the allowed business was narrow.

However, the problems the Chinese banking sector was facing were highly tangible. The underdeveloped banking system with low corporate governance, high NPL ratios, and low CAR threatened the development of the banking sector. Government has tried to amend the high amount of NPLs, but the result did not prove to be sufficient. The Chinese authorities recognized the need of foreign competition to deal with the problems and to stimulate the domestic growth. As a result, the entry into the WTO was a natural and self-evident step.

The accession to the WTO was a milestone for the Chinese banking sector. China was obliged to open up the banking sector for foreign banks to compete on the same conditions as domestic banks within a time limit of five years. As a result, regulations on foreign banks were changed. In 2002, foreign banks were regulatory allowed to engage in RMB businesses with domestic clients and with no regional restrictions. The regulation changes opened up more attractive opportunities for Citi's possibilities to expand in China. With extended business scope for foreign-owned entities, it is logically to believe that Citi's next step would be to extend their branch businesses. However, China's agreement with the WTO was cautiously implemented. New regulations imposed on foreign banks were relaxed compared to earlier regulations but they did not comply with what China and the WTO had agreed on. The Chinese authorities were also slow and unwilling to process foreign applications, thus creating frustration and uncertainty in foreign establishments. Although regulations stipulated foreign banks to engage in several banking services areas, few approvals have been granted by the government and the approval is a time-consuming process. The US and many other countries have filed disputes towards China regarding the compliance to the WTO agreement. The response from China is yet pending. The unwillingness to let foreign banks to have extensive influence in the banking sector can also be found in the requirements and restrictions in acquisition of domestic banks. In order to continue operation in China, foreign banks may still only obey to the restrictions and choose the option best suited for the circumstances.

The unfavorable regulatory environment with weak legal enforcement would be the major factor to why Citi chose the option to acquire. Even though Citi could expand their business in China, the services allowed would still be highly limited by the authorities. The uncertainty in whether Chinese authorities will grant Citi approval to conduct in the range of business they want to diminishes the attractiveness of the option. Reasoning for acquisition based on the real option theory would argue that acquisition will create value to Citi in the form of the option to grow in the future and the option to abandon. The growth value comes with the possibility to explore the market in a smaller scale before fully entering the market with an initial investment. Market uncertainty, unfavorable regulations and insufficient legal enforcement result in higher risk with subsidiary investment than acquisitions of domestic banks. If the acquisition proves to be successful, the opportunity to increase the investment in the domestic banks is thus justified. Citi can grow its stake in domestic banks and through the domestic banks expand in the Chinese market. The possibility to grow the stake in domestic banks is higher than increase the business scope, since Chinese authorities are still very cautious to give foreign banks too much of influential role in the banking sector. The option to abandon is also available if the acquisition show negative outcome. Abandoning an acquired domestic bank is still beneficial, since the shares can be sold back to the public market. The drawback of the option to abandon is that Citi will only be allowed to abandon the acquired stake after three years of possession. The difficult part is to get approval to acquire the domestic shares; with that part reached abandon would not be an issue.

Citi acquired a 5% stake in SPDB in 2002. Even though the purchase would mean that Citi had to tie its equity in SPDB for three years and with no controlling power, this was a half-safe strategy undertaken by Citi as SPDB was over-performing the average banking market. Citi might have seen the possibility to increase their shares to 20% in a later phase as the appealing factor to acquire SPDB. However, restrictions of foreign ownership to a maximum of 20%, implies difficulties for foreign investors to acquire a significant stake and thereby gain management control. Due to the fact that the Chinese authorities had the last say in whether to approve an acquisition, it was difficult for Citi to increase their shareholdings in domestic banks. Moreover, Citi encountered obstacles to maintain their stake in the domestic bank due to the repetitive increases of share resulting in dilution of Citi's stakes in SPDB. Although Citi was granted to increase its stake to 20% in 2006, Citi did not buy more shares in SPDB. The evident reason for this decision might be the fact that the majority stakes was held by the state-owned investors. Assuming that Citi would purchase a 20% share in SPDB, the American bank would still not be able to gain the managerial control of the Chinese bank. With no managerial control the possibility for Citi to expand their business in China is limited. As SPDB performed well, the Chinese authorities might not have seen the need of a foreign strategic investor with influential power as necessary.

Citi took the safe strategy to acquire SPDB. However, with the gradual understanding of the market, Citi took the risk to purchase stakes in CGB. As CGB's prerequisite was rather contrasting, Citi could make use of their edge expertise to turn around the business. Citi that has a global presence, strong capital base and extensive knowledge and experience in banking was chosen as their foreign strategic investor in 2006 in order to improve the business. Citi owned 20% stake and gained operational and managerial control by the government, which was necessary in order to influence the business. To gain managerial and operational control in a domestic bank was very uncommon in China; Citi was offered a great opportunity to extend their market presence. Apart from managerial control Citi could also access CGB's distribution network and reach out to their existing client base. With Citi's leadership and strategic advice, CGB's performance improved substantially compared to before. From negative profit before the acquisition, CGB finally reached a turning point in performance after 2007. The return on equity of CGB even exceeded the ROE of all banking institutions in the previous years. Also, the NPL ratio of CGB has decreased substantially since Citi took over the management.

In December 2006, the newly revised regulations of foreign-funded banks became effective. This was the landmark for foreign banks, as CBRC announced that the license for conducting a full range of banking services would be given out for the first time. However, only incorporated banks would be eligible for an approval of a license, since local customers would not be protected under mere branch agreements. This implied that a locally incorporated bank would achieve the same regulatory status as a domestic bank. At this point of time, establishing a subsidiary became a more attractive and safe option, since Citi has had the experience to deal with the domestic market. By establishing a wholly-owned subsidiary in China, Citi could speed up the expansion of its own branch network and, at the same time, have full managerial control. Most importantly, Citi would be allowed to conduct RMB business, which is greatly desired by foreign banks. Furthermore, the five year time frame of the WTO implementation had come to an end, forcing China to act upon the agreement and relax on the implementation of regulations. Successively, China will have to let foreign banks increase their influence in the Chinese banking sector, leading to a more attractive market to operate in. As a result, Citi officially established its subsidiary, Citibank China, in 2007.

With relaxation in the implementation as a result of the negotiations with the US, Citi has finally received approval to launch their own credit card business in 2012. Credit card business was regulatory allowed to conduct, but in fact the Chinese authorities have refused to act on foreign applications, resulting in unavailability for foreign banks to launch credit cards. It was thanks to the joint cooperation with SPDB that Citi could take part in the launch of a credit card business in 2004. Closely after Citi received the approval to launch its own credit card business earlier this year, the successful selling of the stakes in SPDB was announced. The SPDB shares were sold in a block trade at a price under the market price, implying that Citi wanted to sell off all their shares in SPDB as soon as possible. With small amount of shares and no significant control or influence on SPDB, few evidences were in favor of keeping the shares of SPDB.

8. CONCLUSION

Citi can be seen as a pioneer and role model for foreign banks in China. The American bank has undertaken a flexible strategy in entering the Chinese market. First, Citi entered through the form of representative offices and branches and thereby took a safe strategy. Then it expanded via the acquisition of SPDB that would bring about some risk, and later acquire CGB, that implied a higher risk. Finally, Citi returned to its safe approach and established a locally incorporated bank. Before the accession to the WTO, foreign banks did not have another choice than to open representative offices or branches. The regulations have relaxed gradually since the WTO entry. However, the ease in regulations was rather on paper than in application. The changes opened up the legal opportunities for foreign banks, but were more out of legitimacy reasons. The implementation of the regulations still posed a barrier for entering the Chinese market. The uncertainty in implementation of regulations resulted in that foreign banks chose to not fully invest in the market but increase their presence successively.

Not until recently did the regulations loosen up further and the implementation became stronger. As a result, Citi has managed to establish and grow their business in China step by step. The strategy that Citi has used is very unique for Citi's case, since they have been in China before the accession to the WTO. Latecomers would not have to go through the same steps as Citi, as the market would be more opened. It would be reasonable to see more foreign banks enter the Chinese market.

We believe that China need to further open up to develop, not only in terms of stated regulations but with the implementation and actions. Earlier studies have pointed at that the involvement of foreign banks would have a positive impact on the domestic market. With Citi's activities in China, it has been proven that bad performing banks can be improved by the involvement of foreign banks. In order to further open up to the international market, China would have to comply with its commitments, implement the rules in a satisfying way and allow foreign competitors to be treated on same conditions as domestic actors. There are indefinite opportunities in China; these are only restricted by China's cautiousness to the outer world. Based on our study, we would suggest China to open up its market progressively in order to fully improve and enhance its development.

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10. APPENDIX

APPENDIX 1

The Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions

Article 7

An overseas financial institution engaging in equity investment in a Chinese financial institution shall meet the following requirements:
(1) Its total assets at the end of the previous year shall be in principle no less than US$10 billion if investing in a Chinese commercial bank; no less than US$1 billion if investing in a Chinese urban or rural credit co-operative; no less than US$1 billion if investing in a Chinese non-bank financial institution; (2) Its long-term credit rating for the last two consecutive years assigned by the international rating agencies recognized by the CBRC shall be favorable; (3) It shall remain profitable for the last two consecutive fiscal years; (4) Where the overseas financial institution is a commercial bank, its capital adequacy ratio shall be no lower than 8 percent; where it is a non-bank financial institution, the ratio of its total capital to its total risk-weighted assets shall be no less than 10 percent; (5) It shall have in place sound internal controls; (6) Its home country (or region) shall have in place sound framework and systems for financial regulation and supervision; (7) Its home country (or region) shall have a favorable economic environment; and (8) It shall satisfy other prudential requirements set out by the CBRC.

The CBRC shall have the power to make adjustment to the qualification requirements of the overseas financial institution to reflect the changes in the risk profile of the financial sector and supervisory needs.

Article 8

The equity investment proportion of a single overseas financial institution in a Chinese financial institution shall not exceed 20 percent.

Article 9

Where the combined equity investment proportion of all overseas financial institutions in a non-listed Chinese financial institution is equal to or exceeds 25 percent, the non-listed Chinese financial institution shall be treated as a foreign-funded financial institution by the regulatory authority.

Where the combined equity investment proportion of all overseas financial institutions in a listed Chinese financial institution is equal to or exceeds 25 percent, the listed Chinese financial institution shall still be treated as a Chinese financial institution by the regulatory authority.

APPENDIX 2

The Regulations for the Administration of Foreign Banks and Chinese-Foreign Joint Banks in the Special Economic Zones (effective as of April 2, 1985. Annulled by April 1, 1994)

Article 2

The term "foreign banks" referred to in these Regulations means the branch banks established in the special economic zones by banks with foreign capital whose head offices are based in foreign countries or in Hong Kong and Macao regions and are registered in accordance with the laws of these localities as well as banks with foreign capital whose head offices are based in the special economic zones and are registered in accordance with the laws of the People's Republic of China.

The term "Chinese-foreign joint banks" referred to in these Regulations means banks jointly funded and operated in the special economic zones by banks and financial institutions with foreign capital and banks and financial institutions with Chinese capital.

Article 6

The People's Bank of China shall, based on the application of a foreign bank or a Chinese-foreign joint bank, grant approval for the bank concerned to engage in part or all of the following business operations: (1) loans in the domestic currency and in foreign currencies and discount of negotiable instruments; (2) inward remittances from foreign countries or from Hong Kong and Macao regions and collection of foreign exchange; (3) settlement for export transactions, and mortgage in foreign currency;

(4) exchange of foreign currencies and of negotiable instruments in foreign currencies; (5) investment in the domestic currency or in foreign currencies; (6) guarantees of the domestic currency and foreign currencies; (7) deals in stocks and securities; (8) trust and safe deposit box services, credit and financial standing investigations and consultancy services; (9) outward remittances by enterprises with overseas Chinese capital, foreign-capital enterprises, Chinese-foreign equity joint ventures and Chinese-foreign contractual joint ventures and settlement for their import transactions, and mortgage in foreign currency; (10) deposits in the domestic currency and in foreign currencies and overdrafts by enterprises with overseas Chinese capital, foreign-capital enterprises, Chinese-foreign equity joint ventures and Chinese-foreign contractual joint ventures and by foreigners, overseas Chinese and compatriots from Hong Kong and Macao; (11) handling deposits or loans in foreign exchange in foreign countries or in Hong Kong and Macao regions; and (12) other business operations.

APPENDIX 3

The Regulations of the People's Republic of China on Administration of Foreign-funded Banks - First version (effective as of April 1, 1994)

Article 17

A foreign bank, a foreign branch bank or a joint bank may, in accordance with the business scope approved by the People's Bank of China, engage in part or all of the following business operations:

(1) deposits in foreign exchange; (2) loans in foreign exchange; (3) discounts of negotiable instruments in foreign exchange; (4) investments approved in foreign exchange; (5) remittances in foreign exchange; (6) guarantees in foreign exchange; (7) import and export settlement; (8) buying and selling of foreign exchange on its own account or on customer's account; (9) acting as an agent for the exchange of foreign currencies and for the cashing of negotiable instruments in foreign exchange; (10) acting as an agent for payments against credit cards in foreign currencies; (11) custody and safe deposit box services; (12) credit and financial standing investigation and consultancy services; or (13) the services approved in domestic currency and other services approved in foreign currencies.

APPENDIX 4

The Regulations of the People's Republic of China on Administration of Foreign-funded Banks - Second version (effective as of February 1, 2002)

Article 17

A solely foreign-funded bank, a foreign bank branch or a joint-equity bank may, in accordance with the scope of business approved by the People's Bank of China, engage in part or all of the following business operations:

(1) taking in deposits from the general public; (2) granting short-term, medium-term and long-term loans; (3) handling acceptance and discount of negotiable instruments; (4) buying and selling government bonds and financial bonds, and buying and selling foreign currency securities other than stocks; (5) providing letter of credit services and guaranty; (6) handling domestic and foreign settlement; (7) buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange; (8) exchange of foreign currencies; (9) inter-bank lending; (10) bank card business; (11) providing safe deposit box services; (12) providing credit and financial standing investigation and consultancy services; and (13) other business operations approved by the People's Bank of China.

Article 19

The geographical coverage for the Renminbi business undertaken by foreign-funded financial institutions, and the scope of customers to whom such services are to be provided, shall be verified and determined by the People's Bank of China in accordance with the relevant provisions.

Article 20

To conduct Renminbi business, a foreign-funded financial institution shall satisfy the following requirements:

(1) it has operated in Chinese territory for at least three years prior to the application; (2) it has been making profits for the two consecutive years prior to the application; and (3) other prudential requirements prescribed by the People's Bank of China.

APPENDIX 5

The Regulations of the People's Republic of China on Administration of Foreign-funded Banks - Third version (effective as of December 11, 2006)

Article 2

The term "foreign-funded bank" in these regulations means any of the following institutions approved to be established within the territory of the People's Republic of China in accordance with relevant laws and regulations of the People's Republic of China:

(1) a wholly foreign-funded bank funded by a foreign bank on its own or jointly with any other foreign financial institution;

(2) a Chinese-foreign joint venture bank jointly funded by a foreign financial institution with a Chinese company or enterprise;

(3) a branch of a foreign bank

(4) a representative office of a foreign bank.

The institutions listed in subparagraphs (1) to (3) of the preceding paragraph are hereinafter referred to collectively as operational foreign-funded banks.

Article 29

A wholly foreign-funded bank or a Chinese-foreign joint venture bank may, in accordance with the scope of business approved by the banking regulatory agency of the State Council, engage in part or all of the following foreign exchange and RMB businesses:

(1) receiving deposits from the general public; (2) granting short-term, medium-term and long-term loans; (3) handling acceptance and discount of negotiable instruments; (4) buying and selling government bonds and financial bonds, buying and selling foreign currency securities other than stocks; (5) providing letter of credit services and guaranty; (6) handling domestic and foreign settlement; (7) buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange; (8) acting as an agent for insurance companies; (9) engaging in inter-bank lending; (10) engaging in bank card business; (11) providing safe deposit box services; (12) providing credit information services and consultancy

services; and (13) other businesses approved by the banking regulatory agency of the State Council.

A wholly foreign-funded bank or a Chinese-foreign joint venture bank may, with the approval of the People's Bank of China, engage in foreign exchange settlement and sale businesses.