

Financial Services Alert

**Financial Services Forum
College of Management
University of Massachusetts-Boston**

**Opportunities for US Financial Services Firms
in the Global Arena:
A Pot of Gold at the End of the Rainbow
or a Wild Goose Chase?**



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**Opportunities for US Financial Services Firms
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**Foreword by Arindam Bandopadhyaya
Director Financial Services Forum**

In the *Forum's* October 2003 report *Down But Not Out: The Future of the Financial Services Industry* we claimed that “With social security systems under strain in the U.S. and many other countries there may be international opportunities for asset management companies.” This statement sparked an interesting debate. Some industry experts wholeheartedly agreed. Others were cautiously optimistic at best, arguing that most foreign markets for financial services are rife with impediments that has made and would continue to make penetration extremely difficult. Investors are weary of foreign firms and adhering to regulations makes foreign operations exorbitantly expensive.

The Forum decided that this conversation deserves further continuation. In a summer 2004 Forum working paper (Financial Services Forum Working Paper Number 1001) entitled *U.S. Competitiveness in the Global Financial Services Industry* Professor Lawrence Franko successfully outlines the strengths of the U.S. financial services industry. He writes, “The U.S. has achieved an exceptional position in international finance and financial services. The global competitive position of U.S. financial services firms is particularly strong in investment banking, i.e., in securities underwriting and marketing, corporate restructurings, and merger and acquisition advice. U.S. firms are also dominant in securities trading, brokerage, research and custody, as well as in mutual fund and institutional money management, and in venture capital and private equity. Goldman Sachs, Citigroup, JPMorgan Chase, Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bank of America Securities have over 40% of the world’s investment banking business. .. American firms also conduct more than half of the world’s mutual fund and institutional asset management activity, and at least 85% of the assets managed in the most recently popular financial service, hedge funds, are managed by American companies. State Street, JPMorgan Chase, and Bank of New York dominate securities custody and services worldwide. .. U.S. banks are once again leaders in international government and corporate wholesale banking, after a 1970s boom and a 1980s bust.”

To follow up on this piece by Professor Franko the *Forum* asked three international observers to share their perspectives on foreign markets with which they have had direct personal contact. What follows in this issue of the *Alert* are three articles that provide insight into three important international financial markets.

In the first article, *A Brief Outline of the Financial Services Industry in Australia*, Professor Satish Thosar provides an excellent overview of the commercial and investment banking sector, and the insurance and the credit card industry in Australia.

He also discusses differences between Australian and U.S. practices and concludes that “There are probably niche opportunities to be exploited (by U.S. firms) given that margins in banking, insurance, brokerage and fund management appear high enough to suggest a market structure that tends toward oligopoly rather than perfect competition.”

In the second article, *Opportunities for Foreign Banks in China*, Professor Lin Guo discusses the current banking system in China and the activities of foreign banks in the Chinese market. She concludes that “The persistent growth of China’s economy and recent regulations designed to facilitate growth has provided foreign banks with enormous opportunities. On the other hand, the risk of financial instability caused by poor-performing Chinese banks and money-losing enterprises, the lack of legal and regulatory infrastructure, and the conflicts of interests between Chinese banks and their overseas partners all greatly challenge the foreign banking institutions when they do business in China.”

In the third article, *Expected Prospects in France for US Financial Firms*, Ms. Bernadette Le Jeune describes the two-tiered “pillar” system and suggests that a third pillar consisting of voluntary contributions towards retirement funds is necessary. She goes on to explain why changes in risk taking behaviour may take a long time in the French market and concludes that for U.S financial firms forming alliances with local firms may be the best way of entering the market.

About the Authors

Satish Thosar is an Associate Professor in the School of Finance and Economics at the University of Technology Sydney. His research interests include Corporate Restructuring and Control, Stock Market Volatility issues, Mean Reversion in Security Returns, Asset Allocation Strategies and Initial Public Offerings. Most recently, he has published in *Academy of Accounting and Financial Studies Journal*, *Advances in Investment Analysis and Portfolio Management*, *Journal of Banking and Finance*, *Journal of Banking and Financial Services* and *Journal of Psychology and Financial Markets*. Professor Thosar obtained his Ph.D. in Finance from Indiana University, Bloomington and served on the finance faculty at the University of Massachusetts, Boston. He has previously worked for Bank of America and consulted with Asset Sciences Inc, an Internet financial services company.

Lin Guo is an Associate Professor of Finance at the Sawyer School of Management of Suffolk University in Boston. Her teaching and research interests include financial institutions, corporate finance, market microstructure and international finance. Professor Guo has published her work in the *Journal of Banking and Finance*, *Journal of Empirical Finance* and the *Review of Quantitative Finance and Accounting*. She was a Visiting Senior Financial Economist at the Shanghai Stock Exchange in summer 2004, and is a fellow of the FDIC in 2004. She has also presented her research at numerous international conferences, and is a member of the Financial Management Association International, American Finance Association, and Chinese Finance Association. Professor Guo received her B.A. in International Economics from Nankai University and her Ph.D. in Finance from Boston College.

Bernadette Le Jeune is the CFO of the French Savings and Loans Pension Fund (Paris, France). She manages the pension money of the 46,000 employees of the third biggest retail bank in France. The pension fund is worth 4 billions euros that are invested in bonds, equities, real estate, hedge funds and money market mutual funds. Before this appointment, she was a repo trader with Paribas Capital Markets where she was a market maker on French repos and was in charge of refinancing the bank's bond portfolios and of managing an interest rate risk position on the French yield curve. She was also Assistant Treasurer with Paribas bank where she measured and evaluated the interest rate and currency risks on the bank's balance sheet. Ms. Le Jeune has a Master in Money, Bank and Finance from University of Paris-Pantheon-Sorbonne, a Master in International Raw Materials and Financial Markets from University of Paris IX-Dauphine and an MBA from Institut d'Etudes Politiques de Paris.

A Brief Outline of the Financial Services Industry in Australia

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Overview

Australia has a well-developed financial services sector comparable to the major OECD countries (Australia has been a member since June 1971). The so-called 'four pillars' dominate commercial banking: Commonwealth Bank of Australia, National Australia Bank, Westpac and ANZ Banking Corporation. Government regulators (backed by the political establishment) have made it more or less clear that they will not look kindly upon any consolidation within this group. There are some significant players in the second tier, notably St. George Bank and Suncorp Metway.

Opinion seems divided on whether the Australian commercial banking sector represents an oligopoly or tends toward a more competitive framework. The healthy profit numbers posted by the banks supports the oligopoly position.¹ On the other hand, industry observers comment that the market is over-serviced even saturated. It is telling that despite no overt impediments to foreign capital or regulatory barriers to mergers, no major international bank has attempted a takeover of (or merger with) any of the Australian banks. Citigroup has an independent presence but mainly in the non-retail sector.

In contrast, both in the insurance and investment banking sectors foreign players have a major presence in Australia. For example, AXA (France), Allianz (Germany), AIG (USA) compete with local insurance companies: AMP and QBE to name a few of the bigger companies. Likewise, JP Morgan and Goldman Sachs (USA), UBS (Switzerland) compete for investment banking business with local companies: Macquarie Equities, Austock Ltd. etc.

In the retirement planning area, Australia has moved quite aggressively to promote defined contribution plans over defined benefit plans. It is mandatory for employers to provide a minimum of 9% of the employee's salary toward a superannuation fund, which operates along the lines of 401K (or 403B) plans in the US.² Employees can match contributions under a tax-advantaged system labelled 'salary sacrifice'. The fund management function is generally outsourced to professional fund management companies. Many of these services are offered by various players in the banking, insurance and brokerage sectors but there are also a number of specialist firms that do business exclusively in the mutual/super fund space – for instance: BT Financial Group,

¹ For instance for the financial year ending September 2003, ANZ reported a return on book equity of 17%; this compares to 14% reported by JP Morgan Chase (USA) over a comparable period. National Australia Bank has had some recent setbacks due to losses arising from rogue foreign currency trading and poor results from overseas subsidiaries but their domestic margins are robust.

² The superannuation guarantee is triggered generally if the employee earns at least A\$450 per month and applies regardless of full-time, part-time or casual employment status.

Vanguard (Australia) or Unisuper, Australia's analog to TIAA-CREF, servicing the higher education field. The funds management sector is very competitive and there are well over 3000 funds (not fund families) in existence.

The credit card sector is also very competitive and operates very much along the lines of the US model. Visa and Mastercard dominate market share with the cards being offered by banks, airline companies, major stores etc.

Some differences between Australian and US practices

Australia is ahead of the US in terms of the adoption of electronic banking. It is heading toward being a check-less society. Banks offer free on-line bill-pay services and it is possible to set up one's account to pay any third party electronically. Those without Internet access can pay most bills at post office outlets. It is worth noting that Australia's population is only around twenty million - most of it clustered in five coastal cities: Sydney, Melbourne, Brisbane, Adelaide and Perth.

Mortgage lending is highly competitive and efficient. The major difference is that unlike the US, most loans are on a floating-rate basis. It is possible to get fixed-rate loans but seldom beyond ten years – thirty-year fixed-rate loans are unheard of! This is probably due to the relative lack of depth in the mortgage backed securities market. There are no Australian institutions comparable to Fannie Mae or Freddie Mac that, despite recent troubles involving earnings restatements, are arguably responsible for the pleasant reality that US mortgage borrowers do not have to take on interest-rate risk unless they choose to.

One attractive feature of the mortgage loan arrangement in Australia is that under certain circumstances, it is possible to structure the loan with a flexible redraw facility. This means that if the borrower has some surplus cash, she can deposit it into the loan account and pay interest only on actual loan usage – this is similar to partial principal pre-payment in the US except that she has the ability to redraw the loan at any time.³ Most borrowers who have this facility choose to deposit their paychecks, pay bills etc. directly from this account thereby avoiding the negative interest spread between the checking/savings rate and the loan rate.⁴

Reverse mortgages have not really caught on in Australia even though the country faces much the same demographic issues as the rest of the OECD countries. Many Australian retirees are cash poor but have considerable home equity. However, other than a rather basic unattractively priced product offered by St. George, there do not appear to be any

³ You cannot redraw up to the original loan limit but up to the limit based on the amortization schedule.

⁴ Perhaps this facility is now provided by US lenders but it was not available up until mid-2000, when I left the US to teach at an Australian university.

meaningful mechanisms for unlocking home equity for cash-poor retirees in the Australian market.⁵

Bank fees tend to be high in Australia for retail and small business customers and the major banks are increasingly closing down branches in rural and regional Australia. Customer surveys document this dissatisfaction quite clearly; but perhaps this is part of a general worldwide trend as commercial banks find that servicing small accounts is not cost effective. In Australia, the slack is being picked up to some extent by smaller banks with lower overheads such as Bendigo Bank.

As noted above, the superannuation funds sector is highly developed and competitive. However, compared to the US, the regular non tax-advantaged mutual fund sector is not quite as deep. Minimum investment thresholds tend to be quite high and therefore there is limited access for the small investor to low-fee pure index tracking funds (along the lines of the Vanguard S&P 500 index fund) as well as actively managed funds. While Vanguard has had a presence in Australia since the late 1990s, they appear to focus on institutional and retirement clients. It is possible that due to the relatively small population, the Australian market does not generate the necessary economies of scale that permit US mutual fund companies like Vanguard, T Rowe Price etc. to offer investors asset-builder type accounts with monthly investments as low as \$50 and zero initial investment. For instance, BT Financial requires a minimum initial investment of A\$2000 and A\$100 per month for its *regular investment plan*; AMP is less restrictive with a minimum investment requirement of A\$1000.

Concluding remarks

Australia is generally a sophisticated and well-run economy. It emerged virtually unscathed from the recession that hit the Asia-Pacific region after the currency crisis of 1997. Of all the OECD countries, it was least affected by the worldwide recession induced by the severe market correction in the technology sector in March/April 2000. Annual GDP growth remains healthy in the 3 - 4% range and according to The Economist magazine's forecasts for 2005, it is expected to remain at that level. The interest rate environment is stable though average yields are higher than those in Japan and the US. The Reserve Bank of Australia has raised rates over the last year mostly to cool off an overheating property market. The Australian dollar has strengthened considerably vis-à-vis the US dollar and the yen and the country continues to run current account deficits. However, while these are a worry for economy watchers, they are not yet a cause for major concern. The country is somewhat cushioned against oil shocks because it is a net exporter of natural gas and the mining industry (iron ore, coal etc.) is seeing a resurgence due to massive demand generated by China's manufacturing sector.

Financial services and markets are state-of-the-art. There are probably niche opportunities to be exploited given that margins in banking, insurance, brokerage, and

⁵ See the article: "Unlocking equity with reverse mortgages" by S. Thosar in the *Journal of Banking and Financial Services*, Volume 116, Number 1, February 2002.

fund management appear high enough to suggest a market structure that tends toward oligopoly rather than perfect competition. The disintermediation and commoditization trends that are more readily observable in US markets are further away in Australia.

Opportunities for Foreign Banks in China

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I. Introduction

China's GDP had grown at an average annual rate of nearly 9 percent for the past two decades. With the astonishing economic growth, China is speeding up the opening of its financial markets and institutions to foreign competition. China's accession to the World Trade Organization (WTO) in December 2001 showed the country's deepest new commitment to economic reform.

At the time of the WTO accession, geographical and customer restrictions on foreign banks' foreign exchange business will be removed to enable them to conduct foreign exchange business with Chinese enterprises and households. Moreover, China must allow foreign banks to conduct corporate banking business in local currencies within two years after its WTO entry, and to conduct retail banking with Chinese individuals five years after its WTO entry. Foreign banks in China will essentially get national treatment from Chinese regulatory agencies by the end of 2006. Although the WTO will also bring challenges to Chinese banks, including competition for good customers, talents and market share, the opening-up of China's banking sector is expected to improve the capital structure of Chinese banks, increase capital inflow, bring in modern management and expertise and standardize credit and financial transactions. All of these will enhance banking-service quality and integrate China's banking sector into the global financial system.

In this article, I will start by introducing the current banking system in China, and then discuss foreign banking opportunities in China.

II. Current banking system in China

According to the China Banking Regulatory Commission (CBRC), banking institutions in China can be classified into four categories: (1) the four state-owned commercial banks, (2) joint-stock commercial banks, (3) city commercial banks, and (4) other banking institutions which include policy banks, rural commercial banks, foreign banks, urban credit cooperatives, rural credit cooperatives, finance companies of enterprise groups, trust and investment companies, financial leasing companies and postal savings institutions. The state ownership in the four state-owned banks is 100%, while the state ownership in other banking institutions ranges from 0% to 100%. Most of the Chinese

banks have not been listed publicly. Only four Chinese banks have gone public: Shenzhen Development Bank (Shenzhen Stock Exchange), Shanghai Pudong Development Bank (Shanghai Stock Exchange), China Minsheng Bank (Shanghai Stock Exchange), and China Merchants Bank (Shanghai Stock Exchange).

Table 1 summarizes the balances of assets and liabilities of the banking institutions in China as of the end of June 2004. It shows that the domestic assets of banking institutions in China (in both local and foreign currencies) totalled \$3.59 trillion, up 14.7% from the same period of last year. The total assets of the four state-owned commercial banks, joint-stock commercial banks, city commercial banks, and other banking institutions amounted to \$1.94 trillion, \$523.2 billion, \$184.5 billion and \$940.5 billion, respectively. Table 1 indicates that the four state-owned banks are the dominant institutions that account for about 54% of the assets and liabilities of all the banking institutions in China. Not shown in Table 1 but reported by the CBRC, foreign banking institutions controlled 1.4% of the total banking assets in China as of December 2003.

Despite China's dazzling economic growth, inefficiency and a high level of non-performing loans (NPLs) plague China's banking system. CBRC reported that the NPLs as a percentage of the total loans for the state-owned banks and the joint stock commercial banks were 15.59% and 5.16% respectively at the end of June 2004. However, most independent experts estimate that the true figure for the big-four state-owned banks is a third or more. For years, the big-four banks have been tools for government-directed lending to state-owned enterprises, and they cannot become safe unless they can assess risk and price their products and services according to economic principles.

An important step to strengthen banking supervision in China was the creation of the CBRC in April 2003. The CBRC was created as a new overseeing entity for China's banking sector to take over the bank supervision responsibilities from the People's Bank of China (PBC). The CBRC formulates supervisory rules and regulations governing the banking sector, authorizes the establishment, changes, termination and business scope of the banking institutions, conduct on-site bank examination and off-site surveillance, and take enforcement actions against rule-breaking behaviours. The PBC's responsibility is now mainly to formulate and implements monetary policy, prevents and resolves financial risks, and safeguards financial stability. The Chinese government hopes that the new regulatory framework will provide tighter supervision over domestic banks burdened by NPLs, and speed up reform and reduce financial risks.

Some key structural changes of the big-four state-owned banks have already taken place. On January 6, 2004, the Xinhua news agency announced that the Chinese state injected \$45 billion—one tenth of its foreign-exchange reserves—into the Bank of China and the China Construction Bank. This capital injection will help the banks to clean up their nonperforming loans before their upcoming initial public offerings (IPOs). The main purposes in selling the banks are to change their ownership structure and to commercialize bank lending. The expectation is that banks with improved corporate governance will lend more productively and more prudently than what they are doing

now. Following the capital injection, Bank of China and China Construction Bank were converted to joint-stock companies in August 2004 and September 2004, respectively, paving the way for their forthcoming IPOs.

In short, China's banking sector is undergoing profound structural reforms that aim at transforming Chinese banks into open, sound and competitive institutions. Next, this article discusses the opportunities and challenges faced by foreign institutions under China's current economic and political environment.

III. Foreign banking activities in China

Although foreign banking operations in China had existed for decades, China's WTO entry has greatly facilitated foreign-bank penetration into the Chinese markets. Foreign banking activities in China may take various forms including foreign branch operations, foreign ownership of Chinese banks, expansion into consumer, commercial and real estate lending, etc. Each of these activities is discussed below.

1) Foreign branch operations

By the end of 2001 when China just joined the WTO, 157 foreign bank branches had been authorized to conduct designated banking business in China. That number increased to 192 by April 2004, with 35 new foreign bank branches established over the last two years (He and Fan 2004). The annual number of foreign bank branch openings increased steadily between 2001 and 2003. This may reflect the growing interest of foreign banks in China and the ease of regulation on foreign bank entry. Most of the new foreign bank branches chose to locate in China's large coastal cities. This may reflect the greater profit opportunities for banks in locations with higher per capita income and greater business activities.

2) Foreign equity ownership

According to the Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions that became effective on December 31, 2003, the equity investment proportion of a single overseas financial institution in a Chinese financial institution shall not exceed 20 percent, and the activities shall be granted the approval of CBRC. However, the combined foreign equity ownership in a Chinese financial institution may exceed 20%. If the combined equity investment proportion of all overseas financial institutions in a non-listed Chinese financial institution is equal to or exceeds 25%, the non-listed Chinese financial institution shall be treated as a foreign-funded financial institution by the regulatory authority. If the combined equity investment proportion of all overseas financial institutions in a listed Chinese financial institution is equal to or exceeds 25%, the listed Chinese financial institution shall still be treated as a Chinese financial institution by the regulatory authority.

Foreign acquisition of equity stake of Chinese banks can be a win-win strategy. To the foreign banks, they may benefit from the network and customer base of the acquired Chinese bank and enter the Chinese market quickly. To the Chinese banks, they may benefit from enhanced capital ratio through selling their equity stakes, and from bringing in long-term strategic foreign investors to improve their corporate governance and management. For those Chinese banks that intend to be listed in the future, they may also benefit from picking a strategic foreign investor that promise to buy a large share of their stocks and play a certification role in their future IPOs.

A few cases of foreign equity acquisition of Chinese banks are worth mentioning. One case involves Newbridge Capital, an American private-equity firm, which took control of 18% of Shenzhen Development Bank (SDB) from the government of Shenzhen, for \$150 million in May 2004. The deal permits Newbridge Capital to appoint a majority of the 15-strong board, and thus enables it to run SDB (Economist June 3, 2004). Another case is HSBC Hong Kong's \$1.747 billion cash acquisition of 19.9% of Bank of Communications in August 2004 (China Securities Journal August 7, 2004). After the acquisition, HSBC became Bank of Communications' second largest shareholder, next to the Ministry of Finance.⁶

Some high profile cases in which negotiations between potential long-term strategic investors and the Chinese banks are still going on. Bank of China, the nation's second-biggest lender, said it might sell a stake to an overseas investor this year, before its IPO in the second half of 2005. "We're making very big progress choosing a strategic investor," said Bank of China's spokesperson, Wang Zhaowen, at a press briefing in Beijing. (Bloomberg, October 18, 2004). In the meantime, China Construction Bank, the country's third-largest lender, is seeking foreign company investors as its equity owners. The bank expects that the introduction of foreign companies as strategic investors is beneficial for increasing its capital strength, optimizing its capital structure and diversifying its ownership (China Daily, October 23, 2004). In addition, China Everbright Bank is planning a \$1.1 billion private share sale in the near future. The bank is promoting the new shares to domestic and foreign institutions. A spokesperson with Everbright Bank said the bank is in talks with some foreign institutions that are interested in becoming strategic investors (China Daily September 29, 2004).

Equity ownership of Chinese banks has become an effective way for foreign institutions to enter the Chinese banking markets. Although many foreign banks appear to be willing to acquire equity ownership of Chinese banks, conflicts of interests between Chinese banks and their foreign partners often emerge. It is not the intention of controlling parties to lose their influence over the banking business when the Sino-foreign equity partnership is formed. As foreign banks begin to demand for greater control, domestic parties may attempt to resist.

⁶ For additional deals of foreign acquisition of Chinese banks in the past, see He and Fan (2004).

2) Expansion into consumer, commercial and real-estate lending and private banking

Prior to China's WTO accession, foreign banks in China tend to concentrate in limited areas of business such as trade finance for foreign direct investment and foreign trade-related activities in China. Their transactions were mostly denominated in foreign currencies (He and Fan 2004). Since China joined the WTO, the authorized scope for their business has been increasing, and foreign banks are expanding into greater areas of banking businesses.

Consumer lending

As China's per capita GDP has exceeded the threshold of \$1000, and the consumption capacity of the Chinese households has greatly improved, the consumer-loan markets, especially the credit card and automobile-loan markets, have great potentials. China is attractive for credit card banking due to its fast economic growth and the low number of credit cards already in issue - 3 million at the end of June 2004 (www.pbc.gov.cn), compared with a population of 1.3 billion.

A number of foreign banks have teamed up with Chinese financial institutions to promote the credit card business. In January 2004, Citibank and HSBC Holdings have become the first foreign banks to win approval to issue credit cards on the Chinese mainland. The Shanghai Banking Regulatory Bureau gave approval for HSBC to issue a joint-name foreign currency card with the Bank of Shanghai, while Citibank will team up with the Shanghai Pudong Development Bank (SPDB) to issue the country's first joint-name credit card in yuan and dollars (The CalTrade Report, January 14, 2004).

The auto-loan market in China has also been growing rapidly in recent years. As of the end of June 2004, the outstanding balance of the total consumer loans by financial institutions reached \$216.8 billion, making up 10.6% of the system-wide loans. In the meantime, the loans granted to auto buyers amounted to \$22.1 billion, accounting for 10.2% of the consumer loans. China's average ratio of auto loans to the system-wide loans is much smaller than that of the developed economies, showing that the auto financing is a business with great potential. However, it is important to recognize that the consumer-loan business in China is exposed to risks because of lack of accurate credit reporting system, irrational competitions and volatile durable-good prices.

Commercial lending

Commercial lending has been a focused business area of foreign banks in China in recent years because it is where foreign banks have an edge over domestic banks, especially in working capital management, international factoring, and after-credit services. Some experts believe that this is the area where foreign and domestic banks contend for quality clients. A survey has found that the main clients of foreign banks remain multi-nationals in China and all types of foreign-invested enterprises. Services aiming at domestic enterprises are still at a start (He and Fan 2004).

Private banking

Many foreign banks are courting Asia's rapidly growing number of super-wealthy. Boston Consulting Group estimated that assets under management for China's high-net-worth individuals were \$224 billion at the end of 2003, with an annual growth rate of 17% from 2002 (Economist June 10, 2004). However, the private-banking market in China remains closed because foreign banks cannot offer their services there and Chinese residents are not allowed to invest overseas. Even when the rules change to relieve the extent of market segmentation, foreign banks may find that establishing close personal relationships and building the required infrastructure is costly and time-consuming in China. The implication may be that foreign banks will find it hard to build big market shares unless they are prepared to devote many resources to the private-banking business (Economist June 10, 2004).

4) Financial derivatives products

Large international banks are usually active players in financial derivatives markets. They have a competitive edge compared with Chinese banks in their expertise on the use of financial derivatives to hedge risk, to speculate, and to earn fee income. The CBRC promulgated new rules on March 1, 2004 enabling overseas banks to trade derivatives directly with Chinese companies.

According to Bloomberg (October 12, 2004), ABN Amro Holding NV, Credit Suisse First Boston and ING Groep NV said they plan to start offering derivatives that give Chinese companies protection against fluctuations in currencies as soon as October 2004, the first overseas banks to gain such access in China. Ten banks received licenses in the past two months to trade derivatives as they bid to offer a full array of banking services in China. JPMorgan Chase & Co. and nine other foreign banks applied for licenses and are waiting for approval from Chinese regulators. Chinese banks traded a record \$151.1 billion of currencies in 2003, according to the Shanghai-based China Foreign Exchange Center. Although bankers say that there are currently no data available on the size of China's derivatives market. McWilliam at ABN Amro estimates revenue generated from China's interest rate derivatives market is currently about \$500 million a year and growing.

5) Asset securitization

Since its advent in the 1970s, securitization has become a popular financing tool for countries around the world. Securitized assets in developed markets include a wide variety of financial assets such as mortgage loans, home equity loans, credit card receivables, equipment leases, automobile loans and student loans. In China, asset securitization is still a new concept. The current legal and regulatory framework does not allow for standard securitization. There are legal restrictions in the Company Law, which rule out the establishment of a special purpose vehicle, which is essential for

securitizations. Other difficulties include enforcement of the bankruptcy, contract and tax laws. Instead, current securitization transactions in China have been completed under the country's Trust Law. The law provides the basis for the development of securitization-type transactions using trust structures.

Securitizations in China are mainly used to facilitate the sale of non-performing loans. In 2003, China Huarong Asset Management Company, a state-owned financial institution, was the first company to successfully securitize a portfolio of non-performing loans based on the Trust Law. Chinese banking regulators are researching and conducting pilot programs on asset securitization prior to formulating a legal framework. It remains to be seen how Chinese banking authorities regulate foreign participation of asset securitization in China.

In summary, China's banking sector is undergoing an unusual period of reform and restructuring. The persistent growth of China's economy and recent regulations designed to facilitate growth has provided foreign banks with enormous opportunities. On the other hand, the risk of financial instability caused by poor-performing Chinese banks and money-losing enterprises, the lack of legal and regulatory infrastructure, and the conflicts of interests between Chinese banks and their overseas partners all greatly challenge the foreign banking institutions when they do business in China.

Table 1 Quarter-end balance of the banking institutions in China, June 2004

	All banking institutions	Four state-owned commercial banks	Joint-stock commercial banks	City commercial banks	Other banking institutions
Total Assets (\$billion)	3592.4	1944.3	523.2	184.5	940.5
Annual Growth Rate (%)	14.7	9.8	26.8	18.1	18.8
Share in the banking institutions (%)		54.1	14.6	5.1	26.2
Total Liabilities (\$billion)	3460.5	1865.8	507.0	178.1	909.6
Annual Growth Rate (%)	15.1	10.0	27.2	18.2	19.5
Share in the banking institutions (%)		53.9	14.7	5.1	26.3

Note: The CBRC web site (<http://www.cbrc.gov.cn>) reports the RMB value of the balances of assets and liabilities. Here these balances are converted to the U.S. dollars according to the exchange rate of \$1 = RMB8.28.

1. The four state-owned commercial banks include the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC) and the China Construction Bank (CCB).
2. The joint-stock commercial banks include Bank of Communications, China International Trust and Investment Company Industrial Bank, Everbright Bank of China, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Co. and Evergrowing Bank.
3. The "other banking institutions" include policy banks, rural commercial banks, foreign banks, urban credit cooperatives, rural credit cooperatives, finance companies of enterprise groups, trust and investment companies, financial leasing companies and postal savings institutions.

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Prospects in France for US Financial Firms

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Introduction

As the CFO of a French Pension Fund (the French Savings and Loans Pension Fund which manages the pension money of the 46,000 employees, of the third biggest retail bank in France), I will limit my observations to the prospects of U.S. asset managers mainly with French institutional investors. I will begin with a brief review of recent trends in asset management in France and will continue with expected trends in the future, and the role US financial firms could eventually play.

1. Changes in the pension funds system: More capitalization should lead to increasing volumes if everything goes well.

Driving forces in the asset management business in the last few years has resulted from the structural changes that French pension funds system had to go through. The French pay-as-you-go pension fund system was created after World War II. In a pay-as-you-go system, employees and employers pay monthly a percentage of the salary to Social Security (first pillar) and complementary systems (second pillar, for example, the so called Agirc/Arrco); when the employees retire, she receives a pension depending on the number of years that she has contributed and on the money she has contributed. Pensions can be calculated in two different ways in a pay-as-you-go system: defined contribution or deferred benefit.

- **Defined contribution (DC system):** This is the first pillar system (Social Security). Broadly speaking, in this system, you know how much you pay and what you pay is used today to pay for the pensions distributed now to retired people, but the level of *your pension* will depend on the money received by the Social Security when you retire.
- **Deferred benefit:** Under this system for each euro paid, you get the right to x euros when you retire. This is still a pay-as-you-go system because the money you receive depends on your life span: if you die shortly after you retire, your spouse will get approximately 60% of your pension but if your spouse dies soon afterwards, your children will not receive anything.

Demography has put the pay-as-you-go traditional system under pressure. Big changes have been made in the system in the last 10-15 years. More recently (last year) the number of active years to benefit from full pension has been increased and fiscal incentives to develop individual savings when people are active (which then can be

capitalized to increase revenues of the people when they retire) have been provided. The system created is called the PERP.

Life insurance had previously and for many years been extensively used for the same objective. Although there is no initial fiscal incentive for life insurance, the main advantage of life insurance compared to PERP is that you can pass it on to your heirs. Moreover, the French government has created the Fonds de Reserve des Retraites (F2R) with the money made from privatizations. This will be used to avoid increasing too drastically the rate at which the active people will have to pay in 15-20 years when there will be one retired person for one active person in France. The money managed by the F2R will be soon invested in mutual funds managed by a broad variety of asset managers, selected during after a long and tough competitive process.

France will have to maintain the traditional first and second pillar system because for people who have contributed in this system all their lives, you cannot switch from one system to another without allowing for a transition period. This means that contributions to these pay-as-you-go systems will have to be maintained, and eventually be increased because of demographic pressures.

At the same time, France also has the challenge to create and develop a third pillar, which relies on voluntary savings made by individuals specifically for retirement purposes. Succeeding in developing a capitalized system means that:

1. All active people are aware that first and second pillar pensions will not be sufficient to allow them to maintain their buying power when they retire. There is little doubt that the majority of the French population is aware of that.
2. People manage to continue paying for the first and second pillar *and* start putting additional savings to prepare for their retirement.
3. People learn quickly about finance and financial decisions in the money management area or they trust their usual bankers or eventually new bankers who are experienced in this field.

The necessity to add individual capital to the traditional pay-as-you-go system is clear, but the ways to achieve this is not straightforward. If everything goes well, the money managed by banks, insurance companies and asset managers should increase.

2. More capital, either collective or individual, could also mean more financial pressure, higher expected returns and consecutively more risks taken and accepted.

2.1. Currently, risk attitudes among institutional investors are diverse.

However, the path towards higher risk taking could be long. This is because French institutional investors are diverse and can have very different objectives. Institutional investors in France include insurance companies, mutualized insurance companies

(mutuelles), institutions de prévoyance, institutions de retraite complémentaires Arrco-Agirc, among others. Let me concentrate on *Institutions de Prévoyance* (which is the legal status of the pension fund that I manage) just to give you an idea of the kind of company this is. First, Institutions de Prévoyance are companies which offer other companies the possibility to subscribe insurance packages for their employees. Institutions de Prévoyance can offer contracts that depend on life span, they can also offer insurance contracts in case of an accident or sickness, and they can cover the unemployment risk. Institutions de Prévoyance do not seek to make profits; the decisions are made by a *paritarian board* (the board consists of two halves; people representing the companies affiliated to the institution de Prévoyance, and people representing the people benefiting from the guarantees offered by the Institution de Prévoyance). Institutions de Prévoyance can only operate with the agreement of the Ministry of Social Affairs and they have to follow the same managing and accounting rules as insurance companies.

In the French Insurance Regulation Code, the commitments made by an insurance company have to be represented by equivalent assets. Equivalent assets can only be:

1. Bonds issued by OECD members or supra-nationals.
2. Bonds and short-term notes quoted in OECD countries as long as companies whose headquarters are in an OECD country issue them.
3. Equities issued by companies with headquarters in an OECD country or whose equities are listed in an OECD country.
4. Real estate in OECD countries.
5. Loans and deposits as long as loans benefit from a guarantee from a bank or an insurance company.

Assets can be held directly or through French regulated mutual funds (and certain European regulated funds). If they are held directly, it means that no financial instruments (loans without a guarantee, financial products or real estate outside OECD countries, derivatives products, as well as hedge funds) are allowed. If they are held totally or partially through mutual funds, it is a matter of interpretation to decide whether derivatives products, for example, can be held through a mutual fund. Minimum diversification among the allowed products is also ensured by a quota system. No exchange rate exposure is allowed, and as a result portfolios are not very internationalized today (most investments are concentrated in the euro-zone). The asset allocations of institutional investors are nevertheless diverse. Some have big direct bond holdings, others work only through mutual funds, which can be dedicated to the investor or open to other investors.

2.2. The path towards higher risk profiles could be long.

I do not expect a dramatic change in the asset allocation of the funds in charge of the first and the second pillar. Leveraged products will remain marginal in asset allocations. Equity and bonds exposure will remain high, as well as exposure in inflation-linked bonds. Multi-strategy hedge funds exposure could increase but it will mainly, if not

exclusively, be taken through euro-denominated and French-listed funds. Some investors may be less regulated than others for these kinds of investments.

As far as the new third pillar is concerned, the French people will have to learn to make the financial decisions needed to preserve their buying power once they get retire. I expect that the majority of them will trust first the bankers and insurance companies they already know.

Conclusion

Although asset management is certainly going to remain a good business in Europe in the next years, competition will continue to be fierce among players. I do not expect U.S. players to have a leading edge because for those who are new on the European market, they do not know this market and they are not known. Moreover, most European markets are now and for a long time have been very different from the US market. Long established European players have also shown that they are ready to cut drastically management fees to preserve or increase their market share. Consequently, I believe that U.S. and European partnerships in selected areas will be the most beneficial to all players.