



MAGISTERARBEIT

Titel der Magisterarbeit

The development of financial industry and the relationship
between banks free-entrance and finance security in
China

Verfasserin

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angestrebter akademischer Grad

Magistra der Sozial- und Wirtschaftswissenschaften
(Mag.rer.soc.oec.)

Wien, 2011

Studienkennzahl lt. Studienblatt: A 066 915

Studienrichtung lt. Studienblatt: Magisterstudium Betriebswirtschaft

Betreuer: O. Univ.-Prof. Dipl.-Math. Dr. Jörg Finsinger

Abstract

The Regulations of the People's Republic of China on the Management of Foreign Capital was formally brought into effect on December 11, 2006, which marked that China has honored all the commitments on financial services we had made to the international community when joining the WTO, also marked that the China bank industry was opened up completely. The opening up of bank industry brought in not only capitals and advanced management concepts, products and technologies, and effectively promoted to deepen the financial reform, and increased the financial market enterprises' sense of competition, enhanced the level of competition and improved financial innovation capacity, promoted stable, efficient and safe operation of China's financial industry, thus provided strong and powerful support for the national economic growth. Meanwhile, problem of financial security have begun to bubble to the surface.

Since December 11, 2001, the date of China's accession to the WTO, the Chinese financial reform and financial internationalization process have been greatly speeded, and opening up of the bank industry has become an irreversible trend. China should grasp the opportunity to promote market competition of Chinese financial industry, enhance the diversification of financial products and the services efficiency, change the management principles of China's banking sector, improve the management level, and promote the commercialization process of domestic banking sectors, and ultimately enhance the international competitiveness of China's banking sectors and provide strong and powerful support for national economic growth. At the same time, if the problem that the pressure of opening up the banking sector could be transformed into the pressure of financial security couldn't be handled properly, it would threaten the financial security and finally my lose control over banking sectors, finance, and even the entire national economy and politics. Therefore, this paper proposed a number of recommendations on how to achieve "protect while opening up, opening up while protected" and safeguard the interests of the Chinese economy, financial stability, and ensure China's financial security and economic security.

This paper is comprised of four parts:

Chapter 1: the history and current situation analysis of the opening up of China's banking sector

The main content is a longitudinal analysis from a historical perspective of the opening up of China's banking sector, and the analysis of the current situation of China's banking sector with the theory of "financial fragility".

Chapter 2: comparative analysis of the advantages and disadvantages of Chinese banks and foreign banks

Through comparative analysis of the advantages of Chinese banks and foreign banks (advantages of foreign banks are often disadvantages of Chinese banks, and vice versa), it is found that foreign banks entered China in a large scale through equity participation, shares buying, merger and acquisition, which may lead to national financial security problems.

Chapter 3: comparative study of policies to absorb foreign banks in different countries
By comparative study on the foreign bank administration policy in the United States, Canada, the United Kingdom and other developed countries, as well as Eastern Europe and Latin countries, Asian emerging market economies, it offered four inspirations for the introduction of foreign banks into China.

Chapter 4: recommendations and countermeasures

It put forward to guide the opening up of the banking sector by scientific development concept; appropriate protection to ensure that the Chinese banks dominate the domestic banking industry; enhance the competitiveness of domestic banks, create a fair competitive environment for Chinese banks and foreign banks; attach equal importance to supervision and opening up; establish and improve the early-warning mechanism of financial security; improve and perfect relevant legal systems.

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Chapter 1

The history and current situation analysis of the opening up of China's banking sector

1.1 The history of the opening up of China's banking sector

The opening up of banking sector is an important part of the opening up of Chinese economy and financial industry. Since the reform and opening up, China has gradually opened the operating regions and business field for foreign banks in a planned and systematic way by following the principle of opening up stage by stage and gradually. After China's entering WTO, China accelerated the pace of financial opening-up, with the opening up of banking sector at the forefront. The pace of the opening up of banking sector was obviously accelerated with continuous opening up of the business scope and geographical restrictions, and more and more foreign banks enter China for trial operation. Until December 11, 2006, China's banking sector was opened up fully as it opened up further the RMB retail business to foreign banks.

1.1.1 The opening up process of the banking sector

After the founding of the PRC to 1979, the development of China's banking sector was entirely closed, and assumed a repulsive attitude to foreign banks. From 1979 till now, China's banking sector, as important part of the overall strategy of opening up, began to explore the road to opening up in order to implement the reform and opening up policy, attract more foreign investment in a faster way, and absorb advanced foreign financial services. Looking back on the opening up process of the banking sector, it can be divided into three stages roughly:

The first stage is from 1979 to 1993, which is the period of foreign banks entering and starting to develop. In this stage, the overall strategy of the opening up of China's banking sector is: absorb foreign capital and improve financial services to foreign-funded enterprises, and create a better investment environment through the entry of foreign banks. In 1979, the Export-Import Bank of Japan established a representative office in Beijing, which opened the prelude to the opening up of China's banking sector; In 1981, it's approved that foreign banks could establish

business entities and engage in foreign exchange business in the five special economic zones, named Shenzhen, Xiamen, Zhuhai, Shantou and Hainan; In the same year, Nanyang Commercial Bank established a branch in Shenzhen, which is the first business entity founded by foreign banks in China since the reform and opening up; In 1992, Shanghai became the first to attract and introduce business entity founded by foreign banks among coastal open cities after the special economic zones; since 1992, the region allowed to introduce business entity founded by foreign banks was further expand to seven coastal cities, named Dalian, Tianjin, Qingdao, Nanjing, Ningbo, Fuzhou and Guangzhou. Under the guidance of the policy of adapting to the economic and financial development requirements constantly and promoting the opening up of banking sector steadily, China's banking sector expanded the opening up regions which extended gradually from the special economic zones to coastal cities and central cities. After 13 years development and till the end of 1993, 76 business entities were established by foreign banks in 13 cities in China, dealing with foreign exchange business for foreign-funded enterprises and foreign residents, with total assets up to 8.9 billion U.S. dollars.¹

The second stage is from 1994 to 2001, which is the rapid development period of foreign banks. In this stage, we made a breakthrough in China's economic system reform, speeded up the pace to establish a socialist market economic system, foreign trade has overall development with foreign investment significantly increased, the business of foreign banks developed rapidly along with the rapid growth of foreign-funded enterprises in China and the development of international business for Chinese banks. In 1994, based on the revision and improvement of the "Administration regulations of the PRC on foreign banks, Sino-foreign joint venture banks in special economic zones" promulgated in 1985, China issued "Administration regulations of PRC on foreign financial institutions", which is the first foreign bank management regulations. The promulgation of this regulations guided the operation of foreign banks in China enter to a legal and normalized development track, and the

¹ Chinese banks supervision committees: 《 The report of Chinese banks opening up 》 , 2007,03

policy of the opening up of Chinese banks became more transparent and stable. The opening up regions of banking sector extended nationwide on the basis of the first stage, and foreign banks could establish branches in all cities in China. Aiming to promote the development of foreign banking business further, China issued “Pilot tentative measures of Shanghai Pudong foreign financial institutions engaging in RMB business”, which further opened up the RMB business of foreign-funded enterprises and foreign residents to foreign banks, and accelerated the development of foreign banks in China. Since the Asian financial crisis broke out, the development of foreign banks in Asia became more cautious, and the institution layout and business development in China also slowed down apparently, several foreign banks withdrew from Chinese market. To promote the development of foreign banks in China, the Chinese government adopted series policies timely, approved that Shenzhen will be the second pilot city after Shanghai to allow foreign banks to conduct RMB business; allow foreign banks to enter the national inter-bank lending market to solve the problem of capital sources for their RMB business; relaxed the geographical restrictions of foreign banks conduction RMB business to allow the foreign banks in Shanghai could expand their RMB businesses to Jiangsu and Zhejiang, and allow the foreign banks in Shenzhen could expand their RMB businesses to Guangdong, Guangxi and Hunan. While the scale of foreign currency loans contracted, those measures promoted the development of RMB businesses in foreign banks. Till the end of 2001, business entities of foreign banks reached 177, with total assets up to 45 billion dollars.²

The third stage is from 2002 to 2006, which is the transitional period after accession to the WTO. In this stage, the opening up of China’s banking sector has undergone tremendous changes. China entered the WTO on December 11, 2001. During the five-year transition period, China has seriously implemented its commitments and promoted the opening up of banking sectors in an orderly way. Since the date of entry into the WTO, open foreign exchange business of all customers to foreign banks;

² Chinese banks supervision committees: 《 The report of Chinese banks opening up 》 , 2007,03

gradually expand the regions of foreign banks conduction RMB business nationwide from the four cities at the beginning, named Shanghai, Shenzhen, Tianjin and Dalian; gradually expand the clients of RMB business in foreign banks to Chinese enterprises and Chinese residents from only foreign-funded enterprises and foreign residents. Meanwhile, relax the restrictions on the operation of foreign banks in China, cancel the ratio restriction that RMB liability of foreign banks' shall not exceed 50% of their foreign currency liabilities; ease the ratio restrictions on the absorption of foreign currency deposits in China by foreign banks; remove non-prudential restrictions on the operation of foreign banks in China, and grant foreign banks national treatment on the basis of commitment. The stable opening up expectation and timely policy adjustment promoted the accelerated development of foreign banks. ³

1.1.2 Transitional period for the opening up of banking sector

In the 5 years after accession to the WTO, China significantly accelerated its pace on the opening up of the banking industry, with accumulated opening up degree far exceeding the sum total of the opening up degree since the reform and opening up. But it is different from the opening up of banking sectors in Thailand and Argentina, they adopted radical manner to open up their banking industry in order to absorb a large number of foreign investment in a relatively short time to support national economic development. But China is different, although attracting foreign capital is one of the purposes to open up China's banking industry, but it's not the most important, to see it in a short term, it is even just a alternation condition in exchange for joining the WTO. Therefore, the opening up of China's banking sector is strictly conducted and carried out step by step according to plan.

1.1.2.1 Proposal of the transitional period

After joining the WTO, China didn't committed immediately to fully liberalize and open up the financial sector, but put forward the requirement of five-year transitional period with purpose from the perspective of stabilizing financial order, increasing the buffer time for Chinese banks, improving the international competitiveness of

³ Chinese banks supervision committees: 《 The report of Chinese banks opening up 》 , 2007,03

Chinese banks and perfecting financial market system, which provide a guarantee for financial stability after overall liberalization of the banking industry. Specific process is as follows:

China joined the WTO formally as the 143 member countries of the organization on December 11, 2001 after 15 years of negotiations. But before the negotiation, many industries in China are not completely open, or even completely closed. Banks don't open, insurance don't open, retail industry don't open, only the manufacturing sector open, that means, other than manufacturing industries, all industries including services industry are not open. But at that time, the majority of WTO member countries have completely open up in these industries, so in order to become a member of WTO, China committed to open up to fit with the other members. Meanwhile, China has set up a timetable and required to open up in accordance with this timetable, which means opening up is a process, and this process is the transitional period. The transitional period is essentially a product of compromise during the process of negotiations between China and the WTO. Although as per WTO rules, the member country must grant national treatment to foreign banks on the day of accession to the WTO. However, since Chinese banks are very fragile at that time and need some time to reform and innovation to improve their competitiveness, and then could be possible to compete with foreign banks. Thus, there is the five-year transitional period.⁴

1.1.2.2 Should not rely on the transitional period blindly

Now what we need to pay attention to is the transitional period has gone, there is no other reason to delay the opening up of the banking sector. Actually the opening up of China's banking sector is irreversible even in the transitional period. Before being a member of WTO, we can decide the degree of openness freely without other pressure. But the opening up of the banking sector in accordance with the timetable won't be closed again, which is a commitment to the WTO. On the one hand, it is a powerful driving force for Chinese banks as we have to push the banks to compete on the

⁴ WANG Qiu: "The risk analysis of financial security and the choose of countermeasure after into the WTO" , master thesis of Chinese academy of social sciences, 2003.3

international stage, and also have to speed up the deepening reform of banks, but on the other hand, it is also a huge challenge for Chinese banks as we cannot go back again to protect our own banks by limiting the number of foreign banks, business scope and geographical restrictions.

1.1.3 Analysis of the opening up process of banking industry

Through the sorting of the three stages of the opening up of the banking industry, we can see that the opening up of China's banking industry has gone through a process from strict control to full liberalization. The process is complex and exploring because the opening up of banking industry is not a single opening form, but the combined results of many aspects. It specifically manifested in the following aspects:⁵

1, Institution setting

Foreign financial institutions were specifically prohibited to invest in Chinese banks in the “Temporary provisions on the investment to financial institutions” issued by the People's Bank of China in 1994. The new “Administration regulations on foreign financial institutions” published by the State Council in 2001 stipulated that foreign banks could apply to establish business institutions in any city in China under the premise of meeting several basic conditions. These basic conditions are:

(1) To establish wholly-owned bank, wholly-owned finance company or joint venture bank and joint venture finance company, the total assets of the previous year by filing an application must exceed 10 billion dollars.

(2) To establish branches of foreign banks, the total assets of the previous year by filing an application must exceed 20 billion dollars.

(3) Foreign financial institutions engaging in local currency business must operate in China for 3 full years, and make profits in two consecutive years prior to the application. Meanwhile, we canceled the quantitative targets of operation scales for foreign banks according to the “Administration regulations”. In addition, China liberalized the restrictions on the foreign banks' investment in Chinese banks at the end of 2001, but required that the investment proportion of single institution must not

⁵ Chinese banks supervision committees: 《The report of Chinese banks opening up》, 2007,03

exceed 15%, the investment proportion of all institutions must not exceed 2%. In February 2002, the People's Bank of China announced the "Administrative regulations on the city business outlets setting by commercial banks". The objects referred to in the "Administrative regulations" are not limited to Chinese banks, but also include foreign banks, which suggests that foreign banks could set up city business outlets as Chinese banks.⁶

2. Business regions

Since 2002, China gradually canceled the geographical restrictions on foreign banks engaging in foreign exchange businesses, and the cities where foreign banks could conduct RMB business was extended from Shanghai, Shenzhen to 9 cities named Tianjin, Dalian, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan, etc.

3. Business objects

The customer restriction on foreign banks conducting foreign exchange business had been canceled at the end of 2001 when China joined the WTO, in addition to provide foreign exchange business to foreign customers, foreign banks could also provide foreign exchange services to Chinese customers. But the object of RMB business of foreign banks still limited to foreign-funded enterprises.

4. Number and scale of the institutions

In 2001, China approved 14 foreign banks to set up representative offices in China. According to the latest statistics released by China Banking Regulatory Commission show that as of the end of December 2006, 14 foreign-owned and joint venture foreign legal-person banks were registered in China with 19 branches and subsidiaries; 74 foreign banks from 22 countries and regions established 200 branches and 79 sub-branches in 25 cities in China; 186 foreign banks from 42 countries and regions set up 242 representative offices in 24 cities in China. A total of 27 foreign financial institutions invested in the national and local commercial banks in China, including Bank of China, ICBC, CCB, Bank of Communications, Minsheng Bank and Shanghai Bank, etc.; statistics also show that as of the end of December 2006, business

⁶ Zheng Liangfang, "The research for the opening up of the financial organ", Henan financial manage school journal, 1999

categories operated by foreign banks were more than 100 species, 115 foreign banks institutions were allowed to conduct RMB business, the total assets of foreign banks in China reached 103.3 billion U.S. dollars in local and foreign currency, accounting for 1.8% of the total assets of the financial institutions in China's banking sector, total deposits of 39.7 billion U.S. dollars and loan balance of 61.6 billion U.S. dollars; the total foreign currency assets of 67.6 billion U.S. dollars, total deposits of 17.8 billion U.S. dollars, and loan balance of 35.9 billion U.S. dollars; total RMB assets of 278.8 billion yuan, total deposits of 170.6 billion yuan, and loan balance of 200.3 billion yuan. In addition, the RMB business in foreign banks has developed rapidly, since the end of 2001 it increased by 4.6 times with year all amplitude up to 92%; and the cities opening RMB business to foreign banks has reached 25, 5 of which belongs to opening up ahead of time.⁷

1.1.4 The way that foreign financial institutions enter into China's banking sector

From the above-mentioned process and its analysis we can see that foreign financial institutions could enter into the Chinese banking market through the following ways:

First is set up representative offices. Foreign financial institutions could set up representative offices in China, engaging in consulting, liaison and market research and other non-operating activities.

Second is establish business institutions, including foreign-funded banks (foreign capital banks with head office in China), joint venture banks (joint venture banks co-funded and operated by foreign financial institutions and Chinese companies or enterprises in China), foreign-funded finance companies (foreign capital finance companies with head office in China), joint venture finance company (joint venture finance company co-funded and operated by foreign financial institutions and Chinese companies or enterprises in China), branches of foreign banks (branches of foreign banks in China), foreign-funded or joint venture auto financing company, foreign-funded or joint-venture currency broker company.

Third is to invest in Chinese financial institutions legally established. The

⁷ Chinese banks supervision committees: 《The report of Chinese banks opening up》, 2007,03

international financial institutions (World Bank and its subsidiaries, other government developmental financial institutions, etc.) and foreign financial institutions (financial holding company, commercial banks, securities companies, insurance companies, funds, etc. that registered and established in foreign countries) could invest in the institutions established in China, which includes Chinese-funded commercial banks, urban credit cooperatives, rural credit cooperatives, trust and investment corporation, enterprise group financial company, financial leasing company, etc.

Years of practice have proved that the opening-up policy for China's banking sector has achieved remarkable effects. The opening up of bank industry brought in not only capitals and advanced management concepts, products and technologies, and effectively promoted to deepen the financial reform, and increased the financial market enterprises' sense of competition, enhanced the level of competition and improved financial innovation capacity, promoted stable, efficient and safe operation of China's financial industry, thus provided strong and powerful support for the national economic growth. But for a variety of reasons, Chinese banks, especially the state-owned commercial banks have hidden dangers in many aspects, such as high non-performing assets, single property right structure, inadequate capital fund and weaker operation and development ability, etc. While restricting the banks' profitability, these hidden dangers also weakened the competitiveness of the banks, even became the comparative advantages and profit growth points for foreign banks. Therefore, the opening up of the banking industry is an opportunity as well as a challenge. The process of opening up China's banking sector is also the process of evolving and enhancing the challenges.⁸

1.2 The current situation of China's banking sector - Vulnerability Analysis

1.2.1 Vulnerability analysis of Chinese banks

Years of financial reform has achieved tremendous results, it not only developed Chinese banks' sense of competition, but also greatly improved the competitiveness of Chinese banks. However, due to historical and institutional reasons, Chinese banks

⁸ SHI Jianping, 《The foreign capital buy a share of Chinese-funded banks》, Chinese finance, 2005/06

still have a lot of deficiencies, which don't come from external impact or pressure, but endogenous, that is the vulnerability of banks. The vulnerability of banks is mainly manifested by low capital ratios and high-debt management of the bank.

1.2.1.1 The vulnerability of the financial system

We know that in the periodic movement of modern economy, the operating mechanism which generate and accumulate the energy of financial crisis continuously is the inherent vulnerability of the financial system. The concept of "Financial vulnerability" originated in the early 80s of the 20th century. Minsky (1985) made a systematical analysis of the inherent vulnerability of finance, and formulated "financial vulnerability hypothesis", which thought that the intrinsic characteristics of private credit creation institutions, especially commercial banks and other related lenders forced them to go through periodic crises and bankruptcy waves, and the plight of the banking sectors was again passed to various components of the economic entity, which resulted in economic crisis.

The main concern of the study on financial vulnerability included two aspects, except for the fragility of traditional credit markets from business perspectives, the fragility of financial market is also a major focus of financial vulnerability research. Minsky thought that the speculative enterprises grew in numbers during an economic boom and these enterprises will conduct high-debt operations, and they will plunge into insolvency situation once the economic cycle shift to recession, thus the bank's loans became bad debts and the finance became vulnerable. Therefore, Minsky's studies tend to analyze it from a business perspective. In subsequent studies, information economics put forward that the main cause of financial vulnerability is information asymmetry, and pointed out that information asymmetry can be used to analyze the vulnerability of the credit market and financial market, but this analysis approach still focused on the perspective of credit of financial institutions.⁹

What is financial vulnerability? So far no clear and accordant view was reached in theory, but generally speaking, we could define financial vulnerability in narrow and broad sense both. From the narrow sense, financial vulnerability emphasized that it

⁹ HUANG Jinlao, "Financial liberalization and financial vulnerability", 2000.11.6

was determined by finance's sectors operating characteristic which is high debt operation, also known as "financial inherent vulnerability". From the abroad sense, financial vulnerability refers to a kind of financial state with high risk which refers to risk generation and accumulation in all financial areas, including debt financing and equity financing. Financial vulnerability from the abroad sense were showed as commonly referred to as over-indebted of financial institutions, less secure and cannot afford to the impact of economic cycles or market fluctuations.

There are many causes of the financial vulnerability, but the main cause is the volatility of asset prices and the linkage effects of the volatility.¹⁰ Inappropriate financial asset prices volatility and over-volatility, as well as volatility effects scattered through the powerful inner linkage of financial elements are the main source of risk accumulation for financial systems. For example, both excessive speculation caused by collective non-rational behaviors on the market and the instability of macro economy can result in excessive volatility. This volatility is not independent, which could have impact through the financial markets across time and space, and modern highly developed information technology plays a role to add fuel to the flames.

Demirgu and Detragiahe (1998) the four conditions of instability of the banking system, and the banking system would be deemed instable as long as one condition mismatched: First, the proportion of non-performing assets to total assets of the banking system accounts more than 10%; second, saving action cost accounts for at least 2% of GDP; third, the problems of banking sector lead to large scale nationalization of banks; fourth, the occurrence of large-scale bank run, and take emergency measures such as freezing of deposits, extend bank holidays or government issued deposit regulations.

1.2.1.2 The presentations of China's banking sector fragility

If we measure the Chinese commercial banks according to the above-mentioned indicators, it's easy to find that the fragility of Chinese banks lies in the following aspects:

First, large amount of non-performing assets caused low capital adequacy ratio

¹⁰ HUANG Jinlao, Financial liberalization and financial vulnerability, 2000.11.6

Non-performing asset is the presentation of the vulnerability of the banking system, and also is the important reason of the generation of financial vulnerability in China's four state-owned commercial banks. The direct consequence of huge non-performing assets is low capital adequacy ratio of the state-owned commercial banks and public confidence shaken to the banks. Although having the support of national credit, if the huge number remained high, it will threaten the stability and security of the banking industry and entire financial sector.

Basel capital agreement stipulated that the capital adequacy ratio of banks should not less than 8% and core capital not less than 4%, under this generally accepted and observed provisions in the international banking industry, the condition of state-owned commercial banks is not optimistic. During 1995 to 1998, capital adequacy ratio declined, and the government issued 270 billion yuan special treasury bonds to supplement the capital fund in four major state-owned commercial banks, but this didn't solve real problems, instead it would accelerate soft budget constraints of state-owned enterprises. During the three year after the non-performing assets were stripped off, total assets of the banks continued to increase, but profits became decreased, and the capital adequacy ratio dropped again, as of 2002, only Bank of China's capital adequacy ratio reached 8%, that of China Construction Bank only 6.91%, and that of Industrial and Commercial Bank of China only 5.54%, all are lower than the Basel standard 8.5%. In order to increase the capital adequacy ratio of Chinese banks, the CBRC promulgated the "Administrative measures on capital adequacy ratio of commercial banks" on February 13, 2004. After more than one year of hard work, as of the early 2006, 35 banks' capital adequacy ratio reached 8%, increased 5 banks compared with the early 2005, the assets of the banks reached standard have accounted for nearly 70% of total assets of all commercial banks. But even if Chinese banks as a whole have reached the requirements of Basel capital agreement, the capital adequacy ratio is only 8.8%, and compared with an average 15% or more of foreign banks, we still have a long way to go. (See below figure)

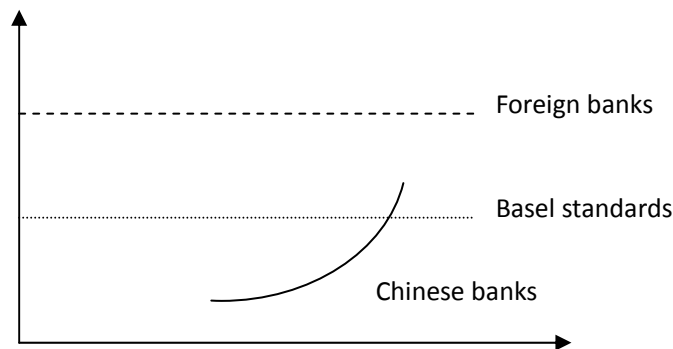


Figure 1: Comparison of capital adequacy ratio of Chinese banks, Basel standards, and foreign banks

Second, high debt operation

High debt operation is the inherent characteristics of the financial industry, as China's capital markets are underdeveloped with single financing channel, so indirect financing is still the main financing form for state-owned commercial banks, deposits account for 65% of household savings, and loans account for 56% of total loans of all financial institutions. Under the contradictions of "borrowing short and lending long", this over-reliance on indirect financing of traditional commercial banks concentrated risks in banks, if enterprises were operated poorly during the process of economic system transition, they would face bankruptcy and closed down which has been described in Chapter two - The process and current situation analysis of the opening up of Chinese banking industry, and thus make a large number of bank loans to be leakage bubble assets. Large amount of non-performing assets would cause bank liquidity difficulties. The vulnerability of the banking system is compared with the stability of the banking system.

Third, in the aspect of China's capital market, the performance of a considerable part of listed companies is poor, and the prosperity of the capital market lacks substance support basis.

The market dysplasia and disorder coexisted, the former was represented by unbalanced market development, incomplete coverage scope, insufficient institutional investors, large amount of investors' margin were misappropriated, the latter was

represented by too large market “bubbles”, serious speculations violated regulations, the interests of individual investors’ can’t be protected, therefore, it will caused the investors lack of confidence in capital market. As the main body of the capital market – certain securities companies not only involved with and carried out security fraud, but also its own basis was very vulnerable.

Fourth, in the aspect of foreign financial transactions, in spite of foreign exchange controls, there are still large-scale capital flights.

Fifth, hidden foreign debts existed abundantly.¹¹

1.2.1.3 The causes of the vulnerability of Chinese banks

Finance marketization is one of the reason caused the financial vulnerability in China, but primary reasons are come from a varied of illegal operations and the excessive expectations and over-reliance on finance. The prominence problem is credit funds became finance, direct financial loans and a large number of policy loans seriously distorted the commercial nature of capitals in banks. After 1990s, China has policy banks, and the previous reason has been weakened, but the capital of policy banks are mainly depended on directed issuance of financial bonds to commercial banks, so this problem hasn’t been fundamentally resolved. To some extent, the accumulated bad loans are rooted in the financial responsibility of State Finance to state-owned enterprises were transferred to the banks. Another problem lead to the vulnerability is variety of illegal operations caused by lack of credit culture and legal spirit during the transition period which was universally occurred during the early 1990s.

Illegal operation is another reason caused the vulnerability of banks. China has a large number of lax law enforcement situations; this has to say is an important reason causing non-performing assets. 1993-1994 is the peak year for non-performing assets of china’s banking sector. A lot of credit funds were used to speculation in real estate, stocks and chaotic development zones construction, after the economy cooling down, the bubble economy was shattered and bank loans became non-performing assets.

In addition, just as the Chinese government perceived that the vulnerability of the

¹¹ LIU Xiaoming, LI Cheng: 《The financial opening up of developing countries》, 《Economist》, 2005.6, 109-116

financial sector was accumulated over many years, which is the comprehensive reflection of deep-rooted problems of national economy. The incompleteness of the reform of the financial enterprise system, national economy soft constraints in business structure, the distortion of financial regulatory actions, the unavoidable government intervention and lack of credit concept and legal scarcity, these five aspects should be the source of the vulnerability of China's finance.

There are several reasons for the vulnerability of Chinese banking system, such as historical or institutional reasons, but the most important reason is the monopoly under state protection. The banking system lacking excitation couldn't have a sound learning mechanism and it is impossible to achieve the space to grow up. The vulnerability of the banking system is the current status of China's banking sector, and meanwhile it will reduce the resistance of China's economy and finance in response to the external shocks. Therefore, our country should make various efforts continuously to change the conditions to achieve effect of "consolidating the foundation"

1.2.2 The vulnerability of the banking system and the national financial security

The vulnerability of the banking system directly affects the financial security of a country, mainly reflected by its generation and accumulation of financial risks, once certain event occurred, it's possible to intensify the accumulated financial risks into financial crisis, especially under the background that virtual economy and real economy disjointed after the expansion of financial market, the vulnerability of banks would have a self-enhancement trend. Therefore, the natural result of the vulnerability accumulation of banks is financial crisis. From a historical point of view, financial crisis keeps happening again and again since finance came into existence. Since the mid 1970s, financial crisis is widespread, from 1980 to 1996, serious problems or crisis happened in 133 member countries of the International Monetary Fund, its frequency and scale is almost "unprecedented".¹²

The vulnerability of banks may lead to financial crisis and endanger the financial security, the main reason is high debt financial development mode is more prone to generate bubbles compared with low debt financial development mode. Once the

¹² LIU Xiaoming, LI Cheng: "The financial opening up of developing countries", "Economist", 2005.6

bubbles burst, it come the financial crisis. The credit played an invaluable role in the forming process of financial bubbles. First is the greatly increased amount of bank credit. The process of credit expansion greatly boosted the investment enthusiasm in related industries and other industries, making the generation of bubbles inevitable; second is the great changes in the structure of bank credit. From the instability hypothesis of Minsky, the enterprises will get loans very easily, but these enterprises are often bubble gatherers, lending money to them will greatly increased financial bubbles. In the bubble formation process, banks and other relevant financial institutions often tend to increase the credit and loans to certain number of speculative businesses, such as real estate companies, financial companies. Just as Kindleberger considered the drastic fall in asset prices triggered by the dumping of financial assets and real estate due to the decline of financial asset prices or real estate prices as abrupt bubble of financial assets bubble or real estate bubble, bank credit in economic expansion period, excessive bubbles constitute bubble economy whose expansion was constrained by social available funds and mass psychology, once market capital support the continuous expansion of the bubble economy or the mainstream of mass psychology changed from over-optimistic to pessimistic, then the bubble economy will inevitably mowing toward burst, often transferred to be the leakage bubble of financial system – non-performing assets, and in turn triggered a financial crisis.¹³

1.2.3 The impact of the vulnerability of domestic banking system to the financial security after foreign banks entered

It is already mentioned of the vulnerability of Chinese banking system previously in this paper, and thought that it's because of the historical, institutional and inherent nature of the generation of the vulnerability became the “defects” of Chinese banks. In the period under rigorous control, although the vulnerability of banks has the potential to endanger national economic stability, financial crisis cannot happen as long as the macro-control of the government is effective. Therefore, there is not much deciding relations between the vulnerability and the stability of the making system.

¹³ PAN Min, CHEN Xinnian: 《Risk and Methods for Chinese bank industry with in the economic opening up》, 《Macro economics management》, 2002.10, 35-39

But the situation changes dramatically after the entry of foreign banks, on the one hand, foreign banks will start to impact China's banking system, while its vulnerability has negative effects to amplify such impact; on the other hand, foreign banks will weaken the economic macro-control capability of the government, and even they will be separated from the control of Chinese government, so the vulnerability of banking system will collapse upon itself the last line of defense of national financial security, and closely linked to the stability of the national banking system.

1.2.4 The offset to the vulnerability by the macro-environment of Chinese banks

The vulnerability is the main “defect” of Chinese banks, on the one hand, it reduces the capacity of Chinese banks to compete against external impacts, on the other hand, it will also increase the effects of financial turmoil. But under the government's highly attention, China's banking industry carried forward the spirit of innovation, constantly deepened the reform of financial system and has achieved tremendous result, and thus portrayed a bright future for future development of Chinese banks while compensating the “defect”.¹⁴

First, the sustained and rapid growth of the macro economy created a favorable macro environment for the opening up. In 2006, the GDP exceeded 20 trillion yuan with 10.5% increase on a year-on-year basis. This means that China has five consecutive years with growth rate more than 8%. Recently, Dr. Huang Yiping, chief economist in great China of Citigroup Global Markets, which is owned by Citigroup, pointed out in his latest macroeconomic research report that China's GDP growth rate this year will remain at 7.5%, and forecasted this level will get sustainable development in the next 10 years. This shows that the macroscopic situation of Chinese economy is good and provides an unprecedented favorable environments and opportunities for the development of China's banking industry. Plus China's foreign exchange reserve has ranked first in the world, and has sufficient international liquidity, and also has a stronger capacity to resist and withstand financial crisis.

Second, the gradually resolved systematic financial risk played the role of stabilizing

¹⁴ LIU Xiaoming, LI Cheng: “The financial opening up of developing countries”, “Economist”, 2005.6

the financial markets. At present, reforms in various fields of investment and financing system for China's banking sector deepened continuously, and China state-owned Commercial bank joint stock system reform were conducted deeply. Meanwhile, the external economic and systematic environment has also made significant improvements, mainly displayed by the significant progress in the interest rate marketization reform, gradually perfected RMB exchange rate mechanism, and the speedy transformation of government functions, further play of the economic and legal means, continuous enhancement of the macro-control ability of the government and so on.

Third, financial trade structural adjustments improved the operating efficiency in a large extent. Meanwhile, under the circumstance of opening up China's banking sector, a large number of foreign banks entered into China, forming the cooperative competition phase between Chinese-funded banks and foreign banks. Although under the condition of complete competition, Chinese-funded banks will be at a disadvantage, but the situation formed based on current government policy, social environment and the operating status of foreign banks in China is more cooperative than competitive, and generated a complementary effect, improved the overall operating efficiency of China's financial and market resources allocation efficiency.

Fourth, the opening up of the banking sector makes it possible to bring in the advance management concept, management style, management structure, expertise and talents of international financial institutions. Foreign banks have many aspects worthy of our study as they started early and developed for a long time. The entry of foreign banks would form a demonstration effect for Chinese banks, thereby change the operation principle of Chinese banks and improve the management capacity, accelerate the innovation on products and services.

Therefore, the opening up of China's banking sector will not cause too many problems to financial security in a relatively short time, just as will be discussed in detail below, the Chinese-funded banks took possession of greater advantages, both on the aspect of outlet construction numbers and customer basis, added that foreign banks are not familiar with China's national conditions and culture, plus their very

small assets proportion, it's impossible to pose a great threat to our financial security. For example, the total assets of foreign banks now are no more than 3% of the total assets of Chinese banks; such a capital ratio doesn't pose much threat to Chinese banks. Even if the RMB retail business was fully liberalized, foreign banks still have a long way to go in China. Another example, the outlets numbers of Chinese banks are far more than that of foreign banks, what kind of choice would Chinese people make during the process of measuring the convenience and quality services? Will they give up convenient outlet of Chinese banks around, but choose to enjoy quality services of foreign banks by sitting for an hour? Obviously not, therefore, for Chinese banks, there are still plenty of time to carry out reforms and construction even in the fully opened today. But we still have to pay attention to the abundant capital behind the foreign banks, and the gradually relaxed control, as well as the "vulnerability" of China's banking system, these elements explain nothing in the short term, but they mean everything in the long run, including national financial security.

In conclusion, China's financial system is bank-oriented financial system, and the banking industry plays a significant role in the development of financial industry. In 2006, the transitional protection period of "entering WTO" for China's banking sector was over, after the full opening up, the reform of China's banking system has entered a critical stage. The entry of foreign banks is likely to endanger China's financial security, while China's financial system, particularly the vulnerability of the commercial banking system is the main "defect" of China's banking system, and will be a hidden mine endangering China's financial security. So how to reform the existing brittle financial system, especially the banking system, and establish a prudent banking system with international competitiveness is the most urgent task.

Chapter 2

Comparative analysis of the advantages and disadvantages of Chinese banks and foreign banks

2.1 The advantages and disadvantages analysis of foreign banks after entering the Chinese market

After China's entering of WTO, the financial industry, especially the opening up pace of banking sector was accelerated rapidly. And on December 11, 2006, China's banking sector opened the door fully to foreign banks, thus foreign banks had crossed the last bottom line which is conduct RMB business. A large number of foreign banks opened branches in China and tried to line out in the Chinese market with its their unique advantages to get a share of profit, but which aspects show the advantages of foreign banks? A clear understanding of the advantages of foreign banks could reflect indirectly the inadequacies of china banks, so that we could fight a hundred battles with no danger of defeat by knowing the opponents and ourselves.¹⁵

2.1.1 Foreign banks possess strong capital strength

Capital strength is the primary condition for the survival and development of banks, strong capital strength could not only provides a guarantee of conducting business for banks, but also could creates premises for the banks' expansion and extension on the international market. In the course of economic globalization and financial integration, the competition in all walks has been intensified, and the competition in the financial industry is growing with each passing day, more and more banks have chosen the road of merger or consolidation, thus the wave of banks merger is sweeping across the world, such as the American City Bank took over the Mexico National Bank (12.5 billion U.S. dollars), HSBS merger with American Household International Bank (15.3 billion U.S. dollars), and Deutsche Bank took over the Lios Bank (70 billion pounds) and other giant merger and acquisition cases.

The Chinese banks fall far behind foreign banks in capital strength, partly because the foreign financial system was established and perfected earlier which provided a good

¹⁵ Wang Zhaoxing, "Foreign bank's supervise and practice", "China's finance", 2005.06

development environment for the development of foreign banks, longer development time than Chinese banks, and capital accumulation is comparatively more; and partly because of the results of M&A of multinational or foreign banks. Each M&A case is a case of “powerful combination”, which resulted in growing capital strength for banks participating in the merger or acquisition, and also providing assurance of adequate capital for further transnational mergers and acquisitions.

2.1.2 Foreign banks have a sound management mechanism

As far back as free competition stage, capitalism has gradually developed its financial and banking system, meanwhile, formed the banking system and bank management mechanism. In the subsequent centuries of development, these systems have continuously improved, while the management experience of foreign banks continues to be accumulated. At present, they have formed a comparatively perfect and scientific management mechanism and strategic decision-making mechanism along with strong risk prevention and business developing capacity.

At the late 1980s, both developed and developing countries formulated a series of informatization strategy according to their actual development, the whole world began to realize the transformation from traditional industrialization to informatization, and information technology achieved great development by leaps and bounds. The development of information technology has changed the people’s life style, saved the operating costs of enterprises, and in the banking industry, it has realized information sharing among banks, enterprises and house holes through the internet, large banks began to invest heavily in trying the network businesses, while trying to make low-cost supervision over the banking business through network information system. Because of the first-mover advantage on time, foreign banks have already owned advance management information system. By contrast, although the reform of Chinese banks has obtained great achievements in recent years, but both the management system and the management information system are comparatively backward, there is still a big gap if compared with the advanced foreign banks.¹⁶

¹⁶ SHI Jianping, 《The foreign capital buy a share of Chinese-funded banks》, Chinese finance, 2005/06

2.1.3 Foreign banks have advanced management concepts

Management concepts are the objective results of long-term operation. After hundreds of years' operation and development, management mode and management concepts accumulated for foreign banks are more advanced than that of Chinese banks. An important difference on the management concept between foreign banks and Chinese banks was manifested by the view on the combining operation. The combining operation has become the trend for the development of management mode in financial industry. Just 3 days before China and the U.S reached the agreement of entering "WTO", both Houses of the United States Congress passed the "Financial Services Modernization Act" and canceled the "Glass - Steagall Act" formulated in 1933, which marked the ending of divided operation in the U.S. and therefore construct a financial "aircraft carrier" integrated with banks, securities, insurance and other financial businesses. But in China, the banking industry has been strictly restricted as divided operation, it has been clearly stipulated in Article 74 of Chapter VII in the "Law of PRC on Commercial Banks" established in 1995 that: " Without the approval, commercial banks are strictly prohibited to issue financial bonds or raise a loan from overseas, buy and sell government bonds or trade and agent foreign exchange, strictly prohibited to engage in trust investment and stock business or invest in real property of non-self use in China, forbidden to conduct investment business to non-financial entities in China... ". The revised "Commercial Bank Law" was only added "Except for the State Council approved". Along with continuous innovation of economy and financial system, as well as financial market, highly development of electronic technology and its full integration with financial industry, such kind of divided operation limited business scope of the banks, the banks not only can't provide a full range of services to enterprises, meanwhile, the risks of their own are increasing as well, so the rationality of its existence is gradually disappearing.

Of course, the advantages are relative as there is no absolute advantage. Advantages and disadvantages can be interchangeable, or even some advantages cannot be played well, for instance, in the reserves of financial management personnel, foreign banks have more high-quality, high-educated personals with extensive banking management

experience compared with Chinese banks, but the talents of these personnel may not always get full play in countries with different national conditions, because they have to adapt to different countries, different economic system, human environment or development mode. In addition, foreign banks have disadvantages as well except for the advantages, such as lack of far-ranging outlets and long-term stable customer basis, and are insufficient of financial professionals with local competitiveness, etc., and all these are the advantages of Chinese banks.¹⁷

2.2 Advantages and disadvantages analysis of Chinese banks after opening up

Although Chinese banks have been far lagged behind foreign banks both in management mode, talent reserves, and experience accumulations, but Chinese banks have clear comparative advantages in network or local experience as they are native institutions of China.

2.2.1 Chinese banks have mature comprehensive network distributions and smooth multi-business marketing channels

After several decades' development and construction, the degree of modernization of Chinese banks has reached a higher level, and has established outlets across the urban and rural areas, only the four state-owned commercial banks have established more than 100,000 business institutions in China, you can see the outlets of the four state-owned commercial banks in any small town of China.

But the current situation of foreign banks in China is mainly “one city, one bank”, they have fewer branches and business outlets within the city, and the market share proportion is not large although it has increased. Although the full liberalization of banking industry provide an opportunity and benefits expansion space for foreign banks, their network outlets and market shares cannot rise very fast subject to their own business risk prevention capacity. And after five years of transitional period, the managerial personnel of Chinese banks have been fully aware of the impact of competition after entering the WTO, and they began the integration of network outlets adjustment, try to constitute outlet networks with more reasonable cost and mature

¹⁷ LIU Yongxin, 《The comparative of chinese banks and foreign banks》, 2005.5, 36-38

distribution, which is the uncomparable advantage over foreign banks.

2.2.2 Chinese banks have long-term stable customer basis and good business reputation accumulated over years

Compared with foreign banks, Chinese banks have edge in terms of customer basis and business reputation. This is mainly because of three reasons:

First, under the same cultural background between banks and customers, such accumulation of the Millennium culture encourages a strong sense of national pride among nationals, and potentially required individuals have mutual trust among each other within the nation, therefore, with several decades of development, Chinese banks have established a long-term customer basis with Chinese residents and enterprises. Such kind of basis required no more obligations fulfilled by Chinese banks, as long as Chinese banks won't change the current operation mode and management concept, they could attract and maintain a broad customer base even after the full liberalization of the banking industry.

Second, the close geographic restrictions on foreign banks make them incapable of increasing customers for a long time, meanwhile, customers' acceptance degree is in proportion with the convenience degree of the bank, Chinese banks have a wide range of outlets, ordinary residents won't give up the domestic banks next to the residence, but travel long distances to foreign banks seeking high-quality services there. The long-term solid customer base further developed a dependence on path, most people would choose to conduct businesses in Chinese banks, such kind of situation won't be change extensively even after the entry of foreign banks in China.

Third is the government support and decades of local management. Commercial banks heads with four state-owned commercial banks are the basis for the macroeconomic regulation and control of the Chinese government, stable operation of the banks is favourable to national economic stability. Therefore, to ordinary people, the banks' conditions are often linked with the government's credibility, and at the same time, commercial banks have set up their good business reputation and their own brands, formed strong relationships with customers with decades of healthy and

steady operations, which are cannot be compared by foreign banks as well.¹⁸

2.2.3 Chinese banks are familiar with local cultures and the financial psychological habits of customers

China is a country with a long-standing history and culture, and also is a traditional agricultural country; the general publics have great difference with western developed countries in the aspect of cultural background, mental habits and continues development exploring experience. The introduction of foreign financial institutions by the opening up of banks will face the conflicts of different cultures inevitably. Finance is an industry closely linked with culture, so while bring in advanced management concepts and products, only foreign banks must integrated two different cultures soundly could they achieve a positive effect. The integration is a process which makes the competition among banking industries is not just the competition over management concepts and financial products, and the competition cannot be consist of only rational competition based on full disclosure of information, “irrational competition” also accounts for a large proportion in the process. This mainly manifested by: first is common people don’t agree with the background of foreign banks; second is lots of things cannot be explained and interpreted solely on cost-benefit subject to the unique development stage. But Chinese banks have the same cultural background with customers, and they understand and know customers’ financial mental habits.

2.2.4 Chinese banks possess strong government support and highly effective financial reform

Compared with foreign banks, another advantage of Chinese banks is the strong government support and the financial reform promoted by the government. The banking system stands an important position for the government regulating and servicing the economy since its formation. During these years after entering the WTO, the government has taken appropriate measures to support and protect Chinese banks, and furthermore, under the unified arrangements of the central government, the

¹⁸ HE Shihong, GAO Qiang: 《Chinese Finance》, Zhongxin Press

mainland accelerated the reform of commercial banks, especially the reform of state-owned commercial banks, promoted internal control construction of the commercial banks, improved their capability of risk prevention. Mainly include: funding to the state-owned commercial banks, the central government appropriated 25 billion U.S. dollars, 25 billion U.S. dollars and 15 billion U.S. dollars foreign exchange reserves respectively to replenish capital fund, promote the joint-stock system reform of the Bank of China, China Construction Bank and Industrial and Commercial Bank of China; build and establish four major financial asset management companies which have successfully stripped off the huge non-performing assets of the four state-owned commercial banks and laid a solid foundation for them to face international competition with light packs; promote the reform of the commercial banks' branches; reform the loan classification system of commercial banks; carry forward unified credit system and loan implementation, etc. These five classifications and measures have obtained initial success and played an important role in promoting Chinese-funded banks to strengthen asset management, improve asset quality, prevent and resolve the risks, etc ^[19]. Currently the banking industry has been fully liberalized, the government will no longer provide extra support for Chinese banks, but it will still provides conditions for the rapid development of Chinese banks through improving the purification of market environment by way of further strengthening the entry assessment of foreign banks. Moreover, other financial reforms in China have achieved substantive results in the past decade, for example, the establishment of three policy banks, the setup of urban commercial banks, the found of the CBRC, the formation of separate supervision pattern in "one bank, three committees regulatory bodies, the reform of institutions of people's bank and the strengthening of the financial regulatory functions, etc. Of course, the disadvantages of Chinese banks are also very obvious, lack of capital strength, imperfect management mechanism, less advanced management concepts and other aspects are the "defects" of Chinese banks which are likely to cause Chinese

¹⁹ LIU Yongxin, 《The comparative of chinese banks and foreign banks》, 2005.5, 36-38

banks to fall behind in the competition. At the same time, the advantages of Chinese banks might become the hunting objects of foreign banks if not fully grasped and gave full play by Chinese banks, and further became “strong” push hands for foreign banks to win the competition, grab the control rights of Chinese banks and implement financial hegemony, and all of these will harm the security of China’s financial industry.

2.3 Possible national financial security problems caused by the entry with priority of foreign banks

The pace of the entry of foreign banks in China has been significantly speeded up in recent years. The aim of their entering into China is to share the fruits of China’s reform and make a profit by catching up the rapid booming economic train in China, if you know nothing more but only this, it is absolutely inadequate and very superficial. Why Henry Paulson, the US Treasury Secretary, has repeatedly urged China to further open its financial markets? Why Goldman Sachs and Merrill Lynch refused to take over banks in China 5 years ago, but are rushing to buy now? Their intention is very obvious. Foreign banks are marching into China through the establishment of representative offices and business institutions, investment in the Chinese-funded financial institutions legally established and other manners, and enlarging their market shares rapidly by using their advantages. In recent years, M&A became their first choice to invest or merger with Chinese –funded banks. The investment of foreign financial institutions to Chinese commercial banks appears to be an irresistible trend as the benefits from such kind of joint ventures and cooperation possess enormous attraction to both foreign financial institutions and domestic Chinese banks. However, if failed to resolve promptly and timely the problems emerged in the investment attraction wave driven by huge benefits, it would not only directly affect the result of capital investment, but may ultimately impact China’s financial security.

2.3.1 The influence of share participation or acquisition on the national financial security

Share participation or acquisition is the product of capital profitability. Under the

trend of economy and financial globalization, the opening up of banking sector, national financial deregulation and development of information technology have provide a favorable environment for M&A. Since the 1980s, there have been many multi-national bank mergers and acquisitions in the world. But what's China's situation? According to relevant statistics, as of the end of November 2006, HSBS participated into the Bank of Communication with 19.9% equity shares, Deutsche Bank invested 110 million US dollars in Hua-Xia Bank, Bank of America invested 2.5 billion US dollars in China Construction Bank, Royal Bank of Scotland and Temasek invested 3.1 billion US dollars respectively to buy 10% share of the Bank of China, and the consortium constituted by Goldman Sachs, Allianz Group and other institutions invested 3 billion US dollar to buy 10% share of the Industrial and Commercial Bank of China...^[20] from this unfinished event list we can see that the scope and scale of the opening up of China's banking sector is unprecedented, and the strong sense and deep degree of foreign banks investing in Chinese banks cannot be ignored. The share participation party or merger and acquisition side may pose a threat to the country's financial security although injected funds to the target party.

2.3.1.1 Reasons for share participation and acquisition of banking industry

From a macro point of view, there are two reasons for the share participation and acquisition of banking industry. First is the deregulation of the host government on foreign banks, which provides a good condition for multinational share participation and acquisitions; second is the rise of financial globalization wave and the increasing fierce competition among larger banks, which forced the bank hosts to look for opportunities for their own banks by standing on the world market. As a result, the coordination and harmony between acquiring party and the host make mergers and acquisitions of banking industry to be a reality.

From the microscopic point of view, the comparative advantages of Chinese banks over foreign banks make the acquisition of foreign banks to Chinese banks profitable. First, the banking industry belongs to financial service industry, foreign banks need

²⁰ WANG Yuxin, 《Financial security, controversies of Chinese opening up》, China economy times

the support of wide range of business network and large numbers of customer service if they want to open China's market, but subject to China's strict access controls in the past, the basis of foreign banks in this area is far behind that of Chinese banks, but share participation or even the acquisition to Chinese banks would entitled the foreign banks to use the business outlets of Chinese banks indirectly, reduce the "fixed costs" of foreign banks, thus it is an important strategy of foreign banks; second, a lot of high-quality financial management personnel are required to carry out banking businesses. Ma Weihua, president of China Merchants Bank, once said that to a large extent, the competition among banks can be generalized as talent competition. Regardless of what kind of walks you engaged in, talents always been the most solid pillars, especially in today's highly developed knowledge economy era. Although foreign banks boast advanced human resources system and training methods, but the differences between countries are likely to cause a dilemma of "a hero with no place to display his prowess " to those senior personnel of foreign banks. Share participation or acquisition would make foreign banks familiar with the talent reserves of Chinese banks and knowledge structure of the senior management personnel in financial industry, and thus provide references to improve and perfect their training system; third, foreign banks should also consider the Chinese characteristics, if simply adopted the way of establish new institutions in host countries, on the one hand, it's impossible to control the time cost and expense cost, while on the other hand, it's likely to suffer from various restrictions from the local banks of the competitive side, even the malicious competition, but through purchasing or acquisition of stock equity could avoid the occurrence of the above situation; correspondingly, Chinese-funded commercial banks who are eager to quickly enhance their core competitiveness to cope with more and more complex competition environment introduced them as strategic investors by taking a fancy of those advantages of foreign banks.

2.3.1.2 The impact of share participation and acquisition to national financial security

Share participation and acquisition of foreign banks to Chinese banks will inevitably lead to the hidden possibility to endanger China's financial security, which are mainly

manifested in the following aspects:

1. Weaken the control force of the central bank over the economy

The central bank usually formulated monetary policy to regulate the development of national economy, but both foreign stock equity holding or controlling are likely to weaken the implementation effects of the monetary policy. One reason is that the prime target of the monetary policy is Chinese banks, a large part of it can't be implemented to foreign banks, thus lack of control or intervention of monetary policy over foreign banks weakened the national regulatory capacity over the economy; the other reason is that the entering of foreign financial institutions into China, their integrated operation mode, complex ownership structure, frequent cross-border capital flows, as well as those different legal accounting practice, all of these put forward higher requirements to China's financial regulation, and are likely to form evading to the control system over banks in China, which indirectly weakened the national regulatory capacity over the economy.

2. Affect China's control right over banks

As mentioned above, the aims of foreign financial institutions purchasing and holding shares of domestic commercial banks can be only acquire part of the equity share and get certain proportion of the profits, but as part of their global strategy, these foreign financial institutions are expecting to finally achieve control of these commercial banks and the corresponding Chinese market shares. In fact, as per the current provisions that the stock ratio of foreign financial institutions shall not exceed 25%, and the stock ratio of a single institution shall no more than 20%, it's not a difficult thing for foreign financial institutions acquire actual control right over Chinese commercial banks. If the equity of Chinese banks is dispersed and scattered, and the shareholding ratio of big shareholders is not high, and has strong sense of share transfer, foreign financial institutions could also obtain the control right over Chinese banks although the foreign investment is no more than 20% or 25%. Where particular attention should be given to is that all the Chinese-funded commercial banks with foreign financial shareholders are domestic commercial banks located in economically developed areas, with better economic profits and lighter historical

burden, as well as possessing a good and bright development prospects, or state-owned commercial banks which have a pivotal position in China, these banks hold a number of China's best financial customer resources and occupancy a considerable market share, once foreign financial institutions controlled these banks, it means that foreign financial institutions has easily captured the most dynamic and potential market in China, which is a severe challenge to the entire financial stability in China.

3. The possibility of confronting with the financial hegemony pushed by foreign financial institutions

As part of their global strategy, while conducting share participation in Chinese-funded commercial banks, foreign-funded financial institutions may also attached many additional conditions which are irrational in order to push their financial hegemony. For instance, some foreign-funded banks will put forward excessively harsh requirements while investing into Chinese-funded banks; some foreign-funded banks will make a sale of their patents, products, management systems, etc. at a real good price by the name of injecting advanced management experience, Chinese-funded commercial banks have to pay a high cost for this every year; some other foreign banks may suppressed the self innovation and business development of Chinese-funded banks and designed the business development plan of joint venture commercial bank only according to their own global strategy, and convert Chinese-funded commercial banks into a branch of foreign financial institutions; and also some other foreign financial institutions took Chinese-funded commercial banks as a tool to pass on their risks, and they will passed on their financial risks in the global market to Chinese-funded commercial banks. All these are manifestations of financial hegemony which will greatly endanger and harm the security of Chinese-funded commercial banks and China's financial industry^[21].

4. Withdrawal of foreign capital might result in financial crisis

The Asian Financial Crisis of 1997 is a good example in this regard. A large number

²¹ SHI Jianping, 《The foreign capital buy a share of Chinese-funded banks》, Chinese finance, 2005/06

of short-term speculative capital in flowed and permeated into all fields of the economy through stock equity participation banks. This has considerably reduced the stability of the economy. The goal pursued by speculative capital is high yield, but also accompanied with high risks. In reality, this may manifested by the strategy established by Chinese-funded banks with foreign equity participation, the strategy also pay attention to high yields without consideration of high risks. And if there emerged the circumstance threatening capital, the rapid withdrawal of speculative foreign capital will further damage the stability of China's financial, and is likely to lead to financial instability, even financial crisis. ²²

Share participation or acquisition to Chinese-funded banks is an important strategic policy of foreign banks. This strategic policy is the inevitable choice of foreign banks on the long-term consideration whether to see it from a macro perspective or from the microscopic point of view. Although Chinese-funded banks may be at a disadvantage during the process of M&A, and M&A itself may be harmful to the national financial security, but this shouldn't become the reason for China to close the door and restrict foreign investment, what we need to do is constantly improve and perfect the construction of local systems, including competition mechanism and protection measures, etc.

2.3.2 The impact to China's financial security of "perfect competition"

After the full liberalization of the banking sector, Chinese banks and foreign banks will compete with each other on the same market, although Chinese banks have some "localization" advantages over foreign banks, for example Chinese banks have the same cultural background with customers, Chinese banks have the strong government support and the financial reform promoted by the government, and so on, but this "localization" advantage cannot be reproduced on the international competition market. What the international rules required are the advantages possessed by foreign banks, like capital strength, management mechanism, management concepts, etc. In the absence of "localization" advantages, the general advantages of foreign banks can be transformed to be local advantages through a variety of ways, such as the situation

²² Li Xiaofeng, CHEN Guang, "Asia financial crisis", Dongnan science, 1998, 4:19

of share participation or acquisition mentioned above, even the foreign banks could achieve the objective of monopoly through using of their strong advantages to crowd out Chinese banks.²³

After opening the banking sector, the competition between Chinese banks and foreign banks will focus on the following areas, but the competition in these areas are mostly dependent on the advantages possessed by foreign banks, thus this so-called “perfect competition” will also be possible to endanger the Chinese banks, and even damage the national financial security.

First is the talent competition. Banking industry is a service industry whose special nature determined that the competitiveness of banks largely depends on the talent reserves. Although solid capital is the guarantee to carry out banking businesses, but only the outstanding talents could give full play to the capitals and bring huge profits for the banks. Therefore, the competition in the banking industry is in nature the talent competition; winning or losing of the talent competition determines the success or failure of banking competition. It has been previously mentioned that since the accession to the WTO, due to the differences in humanity background and operating time, foreign banks is lacking in large amount to talents familiar with Chinese cultures, and is insufficient in talents with extensive experience in local businesses and familiar with the information of the Chinese market and public relations mode. This is a major flaw of foreign banks. But this kind of flaw could be make up with their advantages. As foreign banks could provide competitive compensation package and an open supportive working environment to their talents based on their strong capital strength, meanwhile, they could also attract outstanding talents in China through their advanced training methods, especially overseas training system. Therefore, we can not only see the considerable number of highly qualified financial professional Chinese banks have, but also should aware of outflow of talents in Chinese banks.

Second is customer competition. If we use an old saying to describe the relationship between talents and customers, the most appropriate one would be “You can’t make

²³ YU Yongzhen, “Compete with transnational banks”, the press of the Party school of the central committee, 2006

bricks without straw”. “You” refers to the talents, while “straw” refers to customers. Customers are the sources of profits for banks, no long-term and stable customer base, there will be no long-term and stable development for banks. Benefited from some historical reasons, like the controls over foreign banks by traditional systems, Chinese banks maintained certain amount of long-term stable customer base ever since a long time. But it doesn’t mean that Chinese banks are competitive and highly efficient in services, mainly because China’s banking customers have no other choice but to choose Chinese bank as the only option. But after the liberalization of the banking industry, foreign banks could attract quality customers in China based on their advanced management concepts, superior service quality, high working efficiency and a wide variety of business types. Even if there are blocks of “path dependence” which has been mentioned previously, but there will still be many customers of Chinese banks began to shift, especially those enterprises with high requirements and often dealing with international market who favoured foreign banks. In addition, foreign banks could provide customers with financial, investment and other services after the opening up of RMB business, so individuals with large amount of capitals may also transfer their funds to foreign banks.

Third is business competition. Business competition relies on whether the management concept is advanced or not. After the full liberalization of the banking sector, Chinese banks and foreign banks will also deploy fierce competition on the aspects of financing business, international settlement, and investment and other wealth management business, etc. This competition is actually the competition of management concept, the competition of familiarity with the international businesses, the competition of service efficiency and quality; of course, it is also the competition talents. After the full liberalization of the banking sector in China on December 11, 2006, foreign banks are allowed to conduct RMB retail business. As foreign banks expanded their business scopes and increase business quantity, more deposits of enterprises and individuals would be diverted to foreign banks, and the gap on financing capacity between Chinese banks and foreign banks will be further reduced, or even may be overtaken by foreign banks. Meanwhile, as foreign banks are

perfectly familiar with international businesses, the small gap between Chinese banks and foreign banks on the scale of import and export settlement may also be further reduced. As for the investment and wealth management business, foreign banks have rich “Wall Street experience”. Such kind of legendary experiences can not only attract the attention of Chinese customers, but also are likely to develop this kind of attraction into business development. We know that foreign investment banks are the most active force in the world economy which participated in almost all types of financial markets, and had played a decisive role as well. They have a wide business scope and a wide variety of business types, and operate all securities-related financial products. Under the general trend of combining operation, specific to China’s strict control of separate operation, it is self-evident that wealth management and investment banking will be an important weapon for foreign banks to attack Chinese banks.²⁴

²⁴ ZHANG Biqiong: 《Economic globalization: Risk and Controlling》, Chinese social press

Chapter 3

The comparative study of policies to introduce foreign banks in different countries

3.1 Comparison of policies to introduce foreign banks in different countries

Along with the changes in the international monetary system, a so-called “financial dependency” has been gradually formed between countries, and a wave of global financial liberalization and economic integration has been formed in the world. Each country has initiated corresponding measures to face this irresistible trend. After China’s accession to the WTO, China opened the financial service sector gradually according to the commitments he made in “China's Schedule of Specific Commitments”. The banking industry is the core sector of financial industry, and the opening up of banking industry is an important part of the overall opening up of the financial industry. Therefore, it is an important reference for China’s financial security to have a comprehensive understanding of the policies to introduce foreign banks and the evolution of these policies in different countries.

The theory of financial liberalization is rooted in the well-known financial experts Shaw and Mckinnon’s “Theory of Financial Deepening” and the “Theory of Financial Repression”, they carried out in-depth study on financial deepening and financial repression caused by financial liberalization in developing countries from a different perspective. They thought that “shallow” financial repression policy is obviously harmful to economic development, but “financial deepening” seems helpful to resolve the financial development problems in developing countries under the background of financial globalization.

In fact, the conclusions of the two scholars delivered this policy recommendation which is developing countries should achieve integration with international financial through rational foreign financial policy and domestic financial reform, and the major representative proposal is: interest rate liberalization, reduce government intervention in financial economy, reduce excessive dependence on foreign capital, promote the financial economy through realizing effective financial marketization (or

liberalization), and further to promote the development of macro- economy. They thought the realization of financial marketization strategy could promote the financial growth rate, enhance financial support for investment in capacity, and thereby promote the growth of the national economy through increasing the marginal benefits of investment.

However, all countries have had more experiences and lessons on the opening up of domestic financial markets, the problems is facing the short-term pressures of the opening up of financial sectors, if implement financial liberalization improperly, such as cancel government intervention earlier and carry out the liberalization or marketization of interest rate, or cancel financial market access system, even try to realize the privatization of the banking industry, there will be chain reactions and financial crisis under the influence of strong external forces (such as the impact of international idle capital). From the U.S. saving crisis in developed countries to Mexico's financial crisis in developing countries and the Asian financial crisis proved this point directly.

From the international management experience on foreign banks, we can see that the management of foreign banks in all countries has experienced a process of restrictions – gradually opening up – supervision, specifically speaking, at the moment of introducing foreign financial institutions, all countries had gave priority to restrictions on foreign financial institutions, which will last for a considerable long time, and allowed foreign banks centered on international common business, and domestic business only played a supporting role; centered on the wholesale business, won't encourage foreign banks conducting retail business, and centered on foreign currency business, limit local currency business. Of course, different countries could develop suitable management system on foreign banks according to the development of their financial market and the maturity degree of their financial institutions.

For the convenience of analysis and comparison, we conduct a comparative study by focusing on the management of foreign banks in developed countries, the policy on foreign banks in economic transition countries (Eastern Europe, Latin America) and the management of foreign banks in the Asian emerging market countries, and at last

sum up the management enlightenment of foreign banks in China.²⁵

3.1.1 The management of foreign banks in developed countries

Economic developed major western countries are the pioneers in practicing the management of foreign banks, and they put forward many scientific and prudent management policies, specifically, they have conducted many successful attempts on the aspects of registered capital, organization establishment, institutional characteristics and the operation of banks, as well as supervision of foreign banks. We make the following conclusion on the management of foreign banks in developed countries by referring to the results of comparative study on policies to foreign banks in different countries by Zhou Xing and Lin Qingsheng (2003).

Specifically, the requirements on the capital operation of foreign banks are consistent with that of domestic banks in America, which is based on the U.S sound supervision and management mechanism on banking sector, and as well as its mature financial market. But different with this, the major developed countries of Europe except for the UK have set up detailed provisions on the minimum capital fund of foreign banks. The United Kingdom who practicing continentalism required foreign banks to pay at least 5 million pounds capital fund if they want to establish branches in the UK, and they also should have corresponding net assets, reserves and sources of funds to maintain businesses operation of the banks. Actually we should read and understand such kind of provisions by considering its unique financial system.

Basic means of foreign banks in the financial host countries is the establishment of branches conducting actual businesses, for the United States, the U.S. monetary authorities mainly considers the following factors:

1. Although there is no clear and unified provisions on the registered capital, but it has stringent requirements on the quantity and quality of the registered capital.
2. The impact on domestic economy and trade field, mainly to observe and investigate whether the introduction of foreign banks could facilitate the development of

²⁵ WANG Qiu: 《The risk analysis of financial security and the choose of countermeasure after into the WTO 》, master thesis of Chinese academy of social sciences, 2003.3

economy and trades, and thus benefit the capital gains items of US international financial, moreover, the economic and trade relations between the United States and countries of the foreign banks applying establishment are often became the determining factor for the evaluation.

3. Competitive factor which is an important variable to be considered. The monetary authorities will demonstrate it through the way of assessment as for whether the introduction of foreign banks would caused competition to domestic banks or not and the intensity of competition.

4. The needs of their own people, which is the degree of local public demand for financial services of foreign banks.

In addition to the above-mentioned aspects, the U.S. monetary control and regulatory authorities would also regulate the source country of foreign banks and the total numbers of branches, etc, the United States prohibit foreign banks to set up branches across states, and prohibit establishing both branches and agents in the same state. This can be approved through the concentration degree of the establishment of foreign banks in the United States. According to relevant statistics, over 80% of foreign banks were established in the financial centers like New York, Chicago and other states. The situation can be seen in Canada as it has similar external financial regulation as the United States, and most of the foreign banks in Canada are established in Toronto, Vancouver and other financial centers.

In addition to those many restrictions on the conditions of establishment of foreign banks, the operating of foreign banks seems more relaxed, the operation control of foreign banks is basically the same as that of domestic banks, that is to say that foreign banks could enjoy national treatment. Of course, there are still some limitations on specific business, such as local currency business of foreign banks, whether to enter domestic settlement system, business scale and other fields. Furthermore, there are some restrictions on the entry and development speed of foreign banks, which mainly aim to slow down the competitive pressure on domestic banks. In specific, the management of foreign banks in the United States is mainly to control the credit scale and credit structure of foreign banks in the United States, and

include foreign banks into their national monetary system. Compared to the United States, the neighboring country Canada restrict the development speed of foreign banks, that the ratio of the total assets of foreign banks to the total assets of domestic banks should not exceed 8%, or total assets should no more than 11 billion Canadian dollars. And the western European country Germany once stipulated that foreign banks should not be listed as members of the Stock Exchange. Japan is the developed country introduced foreign banks earlier; it has introduced 23 foreign bank braches in 1949, but only increased 8 in the next 20 years. The emphasis of the banking regulatory authorities in Japan is to constantly digest and adjust these foreign institutions, and this phenomenon remained unchanged till 1970, and Japan has only about 100 foreign banks till now.

In addition, the supervision and control of foreign banks is an important part of the policies on foreign banks in developed countries, the United States, Japan, United Kingdom, Germany, Canada and other countries have made clear restrictions provisions on the aspect of foreign banks liquidity, deposit insurance system, etc.

The most famous is the foreign banks' credit evaluation system introduced by the U.S. regulatory authorities in 1995, the system consists of three levels, first level is the ROCA evaluation of foreign banks conducted on the aspect of risk management, operational control, law compliance and asset quality, etc; second level is the comprehensive assessment on all branches and non-banking institutions of foreign banks in the United States; third level is SOSA evaluation on specific financial situations of foreign banks, the regulatory standards from their home country and risk management capacity, which aims to research on the support ability of foreign banks to its U.S. operations. And obviously this is also the primary means to evaluate operating conditions of foreign banks and financial risks prevention.

In recent years, there has been an upsurge of the banks' risk management assessment in the world, and the recently introduced BASEL-2 protocol is a typical representative, which extended the objects and scopes of risk assessment in BASEL-1, introduced internal rating and other methods, and also affected the management policies profoundly of the foreign banks. Through the study of the policies of foreign banks in

the developed countries, we find that there are restrictions on market access, operating management, supervision and control of foreign banks even in the most economically developed and comparatively market developed countries, and moreover, such kind of restrictions has no trend of relaxation. For the United States, it has gone through three development stages including unilateral concessions after war, national treatment and mutual benefited national treatment, with a policy principle of continuously strengthening the management and restrictions.

3.1.2 Policies on foreign banks in Eastern Europe and Latin American countries

Although being the countries with transitional economy, the policies on foreign banks adopted by Eastern Europe and Latin American countries are greatly different from that of China. Seeing from economic history, most Eastern European countries experienced a Soviet-era socialist construction, and meanwhile, entered into a socialist society by means of “shock therapy” without experiencing too many changes; and most Latin American countries have also experienced similar regime alteration process just like Eastern European countries. These political and historical factors have affected the Eastern European countries’ attitudes towards foreign banks.

Specifically, since 1990s, the Eastern Europe and Latin America became the most enthusiastic regions in the world to introduce foreign banks, and aiming to enhance the competitiveness of domestic banks and their capacity to resist financial risks, the government has played an important role in the introduction of foreign capital, and regarded the introduction of foreign banks as a major part of its financial system reform. Foreign banks took the opportunity to keep pace with the banks of the host country through the acquisition of local banks, set up branches and compete for business. Statistics from the Eastern European countries showed that the control rate of foreign banks is only 7.8% in 1994, while in 1999, it has been rapidly expanded to 52.3%. The engagement of foreign banks in Latin American countries has been relatively high, through constant merger and acquisition events, foreign banks not only occupy large share of the market of the Latin American countries, but also controlled all the financial companies in Latin American countries except for Mexico and Brazil. Many foreign banks in Latin American countries even enjoy the

super-national treatment. It is obvious that the Latin American financial crisis in 1990s has tremendous influence on the reconstruction of the financial market in Latin America.

3.1.3 Policies on foreign banks in Asian emerging market economies

In 1960s, Asian countries entered into a new development period. They learned actively from the policy experiences on foreign banks in the developed countries and developed series of policies on the introduction of foreign banks according to international and country-specific environment. Different from the Western countries, Asian countries maintained a more cautious attitudes on the introduction of foreign banks, and the introduction of many banks was started from pilot project or tests, and the 1997 Asian financial crisis became important reason for Asian countries to restrict the entry of foreign banks and to conduct more controls over foreign banks.

First is the registered capital. In order to ensure financial security, most Asian countries with underdeveloped financial industries established special stipulations on the capital funds of banks based on their national situations so as to ensure and control its development speed. One of the East Asian Tigers, Korea, required certain amount of consent capital on the establishment of foreign banks; other countries also conduct management over multinational banks according to the capital standards stipulated in the new Basel II.

Second is the establishment of institutions. The principle of reciprocity and mutual benefit are upheld by many countries, such as the Korean monetary regulatory authority stipulated that the number of branches of foreign banks established in Korea should not more than two, and only one branch was allowed to set up in the same city, and Thailand stipulated that foreign banks could establish branch only in Bangkok, which has been modeled on the successful experience of many western countries.

Third is the operating restriction. Many countries have set up strict restrictions on the number of branches and share numbers in joint venture banks, and there is no exception even in Singapore and Hong Kong, which are the best financial developed areas, they adopted grading license system on foreign banks and prohibit foreign banks to carry out retail business. Foreign banks could conduct wholesale business

only in Korea, and centered on foreign currency deposits and loans, moreover, they are forbidden to conduct financial businesses in the new field, like trust fund and entrust, and other financial services.

Fourth is the management objective. The financial markets in Asian emerging countries are comparatively vulnerable, even the financial markets of Korea, Singapore and Hong Kong which have been developed earlier, there existed more convergence among their objectives on the management of foreign banks. In specific, first is to protect the normal development of local banking industry, second is to achieve the intended purposes on the introduction of foreign banks, and take different management measures on foreign banks and domestic banks. We note that a very important purpose of the introduction of foreign banks in the Asian emerging countries is to alleviate the shortage of domestic capital, but as the problem of capital shortage being resolved, the main goal of the introduction of foreign banks is to learn from the advanced experience of international banks to enrich domestic financial markets and achieve a diversified pattern. Along with the adjustment of management objectives, the national foreign policies also changed accordingly.²⁶

3.2 Enlightenment to China from the policy experience of the introduction of foreign banks in different countries

As far as the host country is concerned, the entry of foreign financial institutions represented by foreign banks is an obvious double-edged sword for the host country. It brings in advanced management experience of international advanced financial institutions, accelerates the internationalization process of domestic banks, promotes the development of international economy and trade and the establishment of international financial market, but at the same time, it also delivers the pressures of the financial market to the host countries through experiences and lessons from financial crisis and financial deterioration. China has investigated the policy experience on foreign banks in the developed countries, Eastern European and Latin American countries, and Asian emerging market economies, especially the East Asian

²⁶ HU Zhi: 《The theory of financial opening up》, 《Theory guide》, 2003.6, 60-63

Tigers, and put forward some enlightenments on foreign banks to China.

Enlightenment one: opening up domestic and international business gradually and orderly. From the above analysis, we found that the financial policies on foreign banks in all countries, both the developed and developing countries, even the countries at our side, like Korea, Singapore and Thailand and other countries, have adhered to the principle of gradual opening up step by step in an orderly manner. It is clear that the pace of the introduction of foreign banks in all countries has experienced the process of strict beginning and gradual opening up, which must adapt to the development of the financial markets in the host countries, when domestic financial markets can withstand a certain degree of external pressure and domestic financial institutions have certain capacity to compete against foreign banks, in order to meet the development of domestic economy and national needs, we can open up the corresponding foreign banking business in a planned and orderly way step by step.

Enlightenment two: set up foreign regulatory mechanism. The principal organs to implement the policies on foreign banks are those corresponding regulatory institutions. Before the entering of foreign financial institutions, these regulatory institutions began to design appropriate introduction channels; after the entering of foreign financial institutions, they will develop appropriate regulatory measures according to the actual situations, and establish effective monitoring and early warning system. at the moment of introducing foreign financial institutions, all countries had gave priority to restrictions on foreign financial institutions, which will last for a considerable long time, and allowed foreign banks centered on international common business, and domestic business only played a supporting role; centered on the wholesale business, won't encourage foreign banks conducting retail business, and centered on foreign currency business, limit local currency business. For example, the entry permit system implemented in Singapore and South Korea, as well as our quotas control system aimed at QF II are preferable monitoring measures. However, the international financial markets are always confronted with complicated situations, which will affect the whole situation, thus the regulatory institutions must develop appropriate and effect regulatory measures based on prompt and timely consideration

of the situations.

Enlightenment three: improve and perfect foreign financial laws and regulations to achieve the condition that there must be laws to go by, the laws must be observed strictly enforced, and lawbreakers must be prosecuted during foreign supervision. At present, China is not only need to revise and repair the existing laws and regulations, but also need to formulate a series of auxiliary foreign laws and regulations, especially for the index system of foreign banks, such as registered capital, working capital, liquidity, scope and variety of business, and other business, etc, to achieve quantification and institutionalization of the supervision, introduce scientific analytical methods in the formulation of laws and regulations, especially to increase the quantitative management gradually.

Enlightenment four: Risk monitoring on foreign banks must be the important directions of the supervision. Risk is the biggest issue need to consider for the introduction and supervision of foreign banks, Basel II, currently implemented in many domestic banks, extended the scope of risk assessment and introduced new evaluation method. In fact, several bank failures in recent years have caught great attention on the risk monitoring and supervision on foreign banks. And the risks situations of the branches of foreign banks are connected with the head office, so China's regulatory authority should comply with the requirements on international regulatory cooperation stipulated by the Basel Committee, and establish cooperative relationships with the regulatory authorities of the host country where the head office of foreign banks located, and conduct supervisions on the approval and daily risks of foreign banks.

Chapter 4 Recommendations and Countermeasures

The main purpose of the opening up of the banking sector and the introduction of foreign banks is to strengthen ourselves – develop national financial industry, enhance the competitive and survival ability of national financial industry. Opening up is not only for opening up, opening up is not the purpose but only the means. In the long run, opening up of the financial industry will help to improve China's financial efficiency and promote China's financial reform, thus safeguard China's financial security fundamentally. But this process, more of a constructive “destructive force”, which is the opening up driven by external force under the circumstance that the internal reform progressed slowly. During this process, any careless on the policies will cause it easily divorced from the actual level of the development of national economy and financial sector and then generate certain financial risks in the short term. Meanwhile, once handled improperly, China may lose control force over financial industry, thereby reducing its rights on the allocation of social resources. The key issue now is pay attention to control the “quantity” of foreign investment within the scope of national financial security, and how to make effective supervise and promote healthy competition under the commitment of access conditions, and introduce foreign investment with appropriate protection.

4.1 Guide the opening up of banking sector with the concept of scientific development

In accordance with the materialistic perspective, the concept of scientific development is an important world outlook and methodology, as well as the important guiding ideology for the opening up of banking industry. We know that it is a major strategic thinking put forward by the CPC Central Committee with Comrade Hu Jintao as general secretary based on the overall situation of China's economic and social development at the new stage in the new century, and as well as the fundamental guiding principle to build a moderately prosperous society and promote socialist modernization.

In order to implement 16 Fifth Plenary Session spirits thoroughly, complete a good

job of banking sector, especially the policy formulation and implementation, as well as management work of the opening up of banking sector, develop the road of scientific development for foreign banks management, and try hard to promote faster development of China's financial industry, we must firmly establish and implement the concept of scientific development, formulate the strategy of the introduction and supervision of foreign banks truly based on the concept of scientific development, guide the overall situation of banking sector and check the outcome of the opening up of banking industry with the concept of scientific development.

We believe that establishing and implementing the concept of scientific development is the fundamental requirement to promote sound development of the banking sector, even the overall economic and social development. The introduction of foreign banks and the opening up is a key step to link up our banking industry and international banking industry. As the banking industry is a special industry operating money and credit business, it shouldered lots of important responsibilities, like the mobilization of household savings, financing of social capital, management of financial risk, provide payment and settlement services, etc, and it is also the core sector for resources allocation on the market and safeguarding financial and economic security. Both the industry characteristics of high debt and high risk, and the important functions in the economic and social development, require the banking to establish and implement the concept of scientific development. In particular, after the introduction of foreign banks, the competition of business scope and culture scope became the key point for the supervision of both Chinese banks and foreign banks, the concept of scientific development required us to seek truth from facts, be clear about the development status of banking sector, and accurately define the important position of foreign banks in national economic construction which is the primary task of scientific management and policy development.

In addition, establishing and implementing the concept of scientific development is an important premise to eliminate non-rational perception and structural and institutional obstacles which have affected the healthy development of the banking industry. The most fundamental gap between China's banking sector and the advanced international

banks is not the level of specific indicators, but the lack of the concept of scientific development and the structural and institutional obstacle. The introduction of foreign banks will bring in advanced management experience, and effective and favorable competition brings Chinese financial market represented by banks into development state faster and earlier.

4.2 Appropriate protection to ensure that Chinese banks dominate the domestic banking sector

Relevant data shows that so far China was only approved to set up eight banking institutions in the United States, of which 4 are commercial, 4 are representative office. But the United States has 17 banks in China, established 40 institutions, of which 22 are commercial. Speaking from the contrast of capital scale and business capacity, as well as the complex procedures to be fulfilled to access the U.S. market, the so-called “two-way opening” failed to reflect mutual benefit, but only a good wish. Therefore, on the specific operation of the opening up of China’s financial sector, it is necessary to adopt some protective policies in some key areas and weak links, and adjust the access conditions for foreign banking institutions to enter China’s market. While maintain a high degree of opening up of the financial market, the United States also provided protection for its own banking sector, the open policy of financial protectionism practiced in the United States provides us some useful inspirations to protect our own interests.

4.2.1 Reasonable basis for appropriate protection

1. Take advantage of the terms of progressive liberalization in developing countries to open up local market step by step. GATS allows developing countries to realize the liberalization of financial services industry gradually on the aspect of market access according to national policy objectives and the development level of its service industry in order to promote more involvement of developing countries. Based on this, the further opening of China’s financial markets could be conducted gradually through preferential introduction and distribution optimizing in accordance with China’s policy objectives and the development level of the financial services industry, as well as regional distribution. Meanwhile, we could make use of appropriate flexible

terms, try to postpone or reduce the opening of some markets to developed countries according to the affordability of the financial industry, also we could add some legal restrictions in the aspect of market access to gain more buffer time for Chinese-funded institutions.

2. Protect the financial services market properly through taking advantage of safeguard clause and exceptions. WTO and the GATS provide a number of “safeguard clause” or “exceptions” for special circumstances, such as the second item of Article 19 of GATS, members could terminate wholly or partly the agreements already reached. Article 29 of GATS “Appendix on the exemption of obligations of second item” stipulated specifically the exceptions to apply obligations exemption (But this item could be invoked only once). According to this exception, any member could make a list of non-compliance of MFN which will be reviewed by the Council for Trade in Services after 5 year, and its longest period of validity should no more than 10 years. GATS Financial Services Annex also put forward some special treatment and protective provisions for developing members. China is a developing member, so under appropriate or emergency situations, we could take advantage of these terms to protect domestic financial industry legally.

3. Make scientific use of the rule of “prudential Carve-out” in WTO and GATS. In the Uruguay Round negotiations on trade in services, governments of signatories felt that special treatments should be given to financial services and financial industry should be strictly regulated, they thought that the WTO members should have full freedom to take prudential regulatory measures. GATS Article 11 “International payment and transfer” and GATS Article 12 “Restrictions on the protection of the balance of international payment” have stipulated clearly on it. Financial appendix not only excluded the services provided by government by exercising its power (belongs to public or administrative government financial services industry) from the application scope of GATS, it also stipulated a greater exception on prudential supervision, that is Prudential – Out. Article 2 “Domestic legislation” stipulated that members are entitled to take prudent measures contrary to GATS (including the national treatment principle) provisions. Article 3 “Recognition” stipulated the members’ recognition and

confirmation on the prudent measures taken by another member. According to the principle “Special is superior to the general” in law application, the prudential-out in the annex should be given priority in use. In the Annex, it wrote that “no matter how the other provisions of this agreement stipulate” which indicate that no matter whether the members has made a liberalization commitment or not, they have right to take control and regulatory measures to protect the stability of the financial system and the interests of depositors, etc. and these control and regulatory measures are exempt from the liberalization terms of GATS and are superior to relevant provisions of GATS. As for what kind of regulatory measure is prudent, GATS didn’t define or enumerate list, and other organizations engaging in the study of regulatory standards like the Basel Committee on Banking Supervision (BCBS) also didn’t define, but only introduce the best practices in the above-mentioned areas for reference. Thus, it is quite difficult to distinguish a measure be actual prudent measure or disguised protectionism. And this gives members the space to choose prudent measures freely. Facts show that most countries would take some protective measures on their banking industry while open their financial markets. Among 135 WTO members, 122 countries have certain restrictions on the market and business access of foreign banks.

4.2.2 Recommendations of appropriate protection

4.2.2.1 Strictly regulate the proportion of foreign equity participation

The proportion of foreign equity participation in Chinese banks is a significant indicator to measure the control power of financial resources, which indirectly related to the depth and scope of foreign banks participation in Chinese banks business decision making. It is always a sensitive issue, and many countries have set a upper limit on this. Second is the control of management information. Foreign capital’s entry into China’s banking industry involves the issue of sharing the management information resources. Such information covered a wide range, including personal and corporate credit information system, and social information resources, etc, which should be under control of Chinese banks or correspondent Chinese institutions. According to the provisions of the Singapore banking regulations, if a bank’s control power lies in the foreign government or government agency, it won’t be approved to

conduct banking business in Singapore. The key point for this restrictive provision is 50% control right or the management personnel are appointed by the government or its agencies. DBS is the institution controlled by Singapore government, in which Temasek holds 28% of the shares, others are public shares. But the personnel appointments of DBS are determined by Temasek as the controlling shareholder. So far Chinese banks have not received a full banking license in Singapore, while Temasek and DBS, institutions controlled by Singapore government, purchased large amount of the shares of Chinese banks and fund management companies, they even want to control a national scale bank in China. Why we didn't have similar policy like that of Singapore government?

We should continue to maintain absolute control right over the state-owned financial institutions in the process of the introduction of foreign strategic investors. On the one hand, pay attention to country-specific strategic investors, and should not focus too much on some or certain kind of countries. From China's practice of introducing foreign investment, we have already taken sufficient attention on this problem. Foreign financial institutions with equity participation are quite dispersed on the aspect of home country and mechanism. On the other hand, the policy bottom line that the share proportion of single foreign financial institution should not exceed 20%, and the proportion of all foreign financial institutions should no more than 25% should not be broken recently. At the same time, we must highly concern about and properly handle the problem of over-low assets evaluation or over-high of the introduction of foreign investment emerged in the process of the introduction of foreign investment in order to prevent the loss of state-owned financial assets.

Strictly limit the proportion of foreign capital participation, specify and refine the rules of foreign capital participation. Because of the importance of financial sector, all governments would set up some obstacles on the entry of other countries' financial capital, and have strict restrictions on the ownership acquisition of foreign banks in domestic banks, and as a matter of fact, developed countries are stricter than developing countries. We take the United States as an example, which has the highest degree of financial liberalization, the acquisition of foreign capital and the U.S.

financial market access must accept dual review and investigation of federal and state authorities, “Bank Holding Company Act” stipulated that more than 5% share must be approved by the Federal Reserve Board. And the lessons of Indonesia learned from Southeast Asia crisis should also be a lesson for us. Since mid 1990s, Indonesia relaxed the equity ratio restrictions, especially in the financial field, it allowed foreign capital to hold 10% shares in non-bank financial institutions and listed companies. Indonesian government’s extraordinary financial liberalization and investment liberalization has laid hidden perils, and caused it suffered heavy losses in the Southeast Asia Crisis, its economy severely deteriorated and even regressed. Therefore, as for the introduction of foreign capital, what we have to consider is not whether to further remove restrictions and expand the scope of access, but to see whether the openness is too large and too fast, whether it endangers national interest or not. To be precisely, the pace of the liberalization of financial sector should not be further accelerated, and also should strictly control the proportion of foreign capital participation in Chinese banks, must not distinguish different regulatory modes based on whether listed or not, especially the four major state-owned commercial banks must maintain absolute control of state-owned capital.

4.2.2.2 Control of foreign banks’ entry speed

Many countries have adopted appropriate measures to control the distribution of foreign banks home country, total numbers and foreign bank branches numbers, thereby to ensure the share of domestic banks in the banking system to prevent monopoly operation or control of foreign banks in its domestic financial markets. Such as Greece, Korea, Mexico, Philippines, Singapore, Thailand, Turkey, etc, all of these countries have set up strict restrictions on the establishment of branches of foreign banks. The approved foreign banks to enter Taiwan are only 2-3. The comprehensive control standard (CCS) developed by the United States is very strict, many foreign banks have been turned away.

China should learn from the access conditions and regulatory measures on foreign banks in other countries, and control the entry speed of foreign banks. The approval rate on foreign banks should be appropriate to avoid the influx of foreign banks in a

short time.

4.2.2.3 Control of the expansion speed of foreign banks

It is commonly used measure in some western countries to conduct effective supervision through requirements on the asset size and operation performance of foreign banks, thereby to achieve the purpose of adequately control on the expansion speed of foreign banks. Take Canada as an example, its banking law stipulated that the proportion of total assets of all foreign banks to total assets of domestic banks should no more than 8%, or total assets should not exceed 11 billion Canadian dollars. On the supervision of foreign banking institutions, according to the requirements of “International Banking Act”, the branches and agencies registered in the United States must deposited certain amount of funds in the designated deposit bank by way of cash or qualified securities, and the amount shall not less than 5% of liabilities of the branches or agencies, or equate capital fund of local joint registered banks. Hong Kong and many other countries and regions have adopted banking business license system that control the number and size of foreign banks engaging in different scope of businesses by setting licenses of various levels. It is necessary for China to learn from this and appropriately control the expansion speed of foreign banks.

4.2.3 Continue to promote the banking reform dominated by state-owned banks, and try to make the state-owned commercial banks larger and stronger

China’s banking sector, especially state-owned commercial banks, must speed up the reform and improvement of their own, establish and perfect a modern commercial bank operating mechanism in line with market economy requirements, linked with international practice with characteristics of scientific decision-making, supervise and restraint, internal mechanism, self-development and self-discipline. The most prominent is to solve: improve the governance structure of commercial banks, business operating should follow market rules and prudent accounting principle, streamline the organization and personnel, reform and improve management systems, shift the management mode from separate operation to comprehensive operation, etc, and make the state-owned commercial banks larger and stronger.

4.2.4 Opening up internally and externally at the same time

While conducting full liberalization of financial industry, we should strengthen the role of private capital in the financial market, and develop a diversified multi-level financial institutional system. Encourage the development of medium and small financial enterprises with various ownerships and in different regions, and take it as the breach to deepen the financial system reform. The existence of large number of small and medium sized financial enterprises will not bring financial risks, but will become the fundamental force rooted in the local economy to effectively resist foreign financial impacts. And only the development of small and medium sized financial institutions could solve the problem of small and medium sized companies and farmers having difficulty taking out loans, as they could served the capital to each micro-economic agents just like the capillaries.

The existence of large number of small and medium sized financial enterprises will not bring risks, but will become the fundamental force of the local economy to effectively compete against foreign competitors, which is beneficial to the maintain of financial operations and financial markets, and keep away systematic risks.

4.3 Enhance the competitiveness of domestic banks; create a fair competitive environment for domestic banks and foreign banks

4.3.1 Gradually eliminate the super-national treatment of foreign banks

The Chinese government, especially some local governments has taken a lot of tax relief and other incentive measures to attract more foreign financial institutions. This is necessary at the early state of opening up, but such kind of “super-national treatment” of foreign financial institutions must be eliminated gradually after the full liberalization of the financial sector. For example, unify income tax rates and business tax rates on domestic and foreign banks as soon as possible, cancel those tax relief and other incentive measures to the foreign banks by the local government, ensure a fair competition between domestic financial institutions and foreign financial institutions.

4.3.2 Alleviate the burden of state-owned banks, and give commercial banks the autonomous right of business operation

Government should change its functions, and take the initiative to break the

administrative barriers impede fair competition, like protection, market segmentation and monopolies. For the internal market, it is marketization; reduce the state or government control mainly presented in three aspects: first, the state-owned commercial banks will no longer bear the responsibilities of macroeconomic regulation and control, which will be shouldered by the central bank fully; second, all the policy-related businesses burdened by state-owned commercial banks will be taken by various policy banks; third, the business operations of state-owned commercial banks will be conducted in full accordance with the principle of commercialization, and the commercial banks should have complete decision-making rights in the lending and investment, and the restrictions on body establishment also should be relaxed, and truly implemented the autonomous right of business operation entitled to commercial banks in the “Commercial Bank Law of PRC”.

4.3.3 Relax control and promote innovation

Regularity laws and regulations have long been with a feature that it is prohibited if there is no express stipulation. And this to some extent confined financial innovation. Currently, we have conducted a lot of studies and made great efforts on the construction of regulatory laws and regulations, which is the first driving force for financial innovation.

4.4 Pay equal attention to supervision and opening up

Under the premise of strictly compliance with the basic principle of the WTO, strengthen the prudential supervision of the continued influx of foreign banks became a major challenge to the banks regulatory authorities. Properly handle the relationship between supervision and opening up, change the phenomenon of “take seriously examine and approve, ignored is superintended” emerged in the past opening up. Financial liberalization is dynamic integration of financing efficiency and financial supervision, to perfect the legislation and improve the regulatory capacity will be conducive to the further opening up of China’s financial sector. On the contrary, under the circumstances of no supervision or ineffective supervision, the implementation of financial liberalization will lead to many adverse consequences.

4.4.1 Improve the level of prudential supervision on foreign banks

Further strengthen controls on capital inflows and outflows, enhance the ability of prudential supervision in the financial sector. The opening up of financial industry doesn't mean to relax capital controls and lower standards of prudential supervision, on the contrary, only by strengthening capital controls and enhancing prudential supervision ability could the financial industry get greater liberalization and promote faster marketization process. Under the circumstances that domestic financial system can't withstand mass in & out of capital, it's not suitable to relax controls on capital inflows and outflows although faced with tremendous pressure on the exchange rate appreciation. Of course, once conditions are ripe and caused significant constraints to the development of China's financial industry, the unreasonable capital control should be relaxed. And with the deregulation of financial institutions, and the deepening of the opening up of financial institutions both internally and externally, capital market achieved great development and the competition in financial industry was intensified, thus to improve the level of prudential regulation and supervision of the financial industry becomes one of the key factors to ensure the security of financial system.

4.4.2 Strengthen the coordination of different financial regulatory authorities

We should prevent foreign capital take advantage of incoordination among regulatory authorities and enter into numbers of financial sector to enforce combining operation in advance, which would produce potential risk factors to Chinese financial industry under the circumstances that the regulatory coordination level is low. CBRC refused to allow foreign financial institutions conduct share participation in more than two banks, to some extent such kind of regulation has taking into account of the above-mentioned factor. However, the three regulatory authorities should strengthen the coordination further on the provisions of the introduction of strategic investors.

4.4.3 Establish effective risk management and market exit mechanism

Under the circumstances that the external supervision failed to prevent the exposure of banking institutions' risks, which is the regulatory authorities should take timely and decisive measures once the net capital of the banks becomes negative. Commonly used measures include the replacement of senior management; regulators take over, stop business operation for rectification, etc. The regulator must take quick action to

prevent further losses before the interests of the banks being exhausted. If the banks really can't continue to operate, it must adopt the exit mechanism, like acquisition and liquidation. In the market exit stage, the deposit insurance system could protect the interests of depositors well and eliminate the motivation of depositors ran on the bank. Actually many countries have already integrated deposit insurance system into the scope of government obligations from the benefit of social stability or political interests. China should also connect with international standards and speed up the establishment of deposit insurance system.

4.4.4 Strengthen the cooperation with regulatory authorities in the home country of the foreign banks

Build up a unified regulatory network system, effectively prevent and resolve global financial risks together, including: take into account of the cooperation factor with regulatory authorities in the home country when setting up legal systems of foreign banks supervision; conduct comprehensive evaluation on the operation, financing, management, etc of foreign banks head office and branches to improve regulatory effectiveness in a wider scope; carry out detailed and all-round consultation and investigation to the regulatory authorities in the home country to ensure the quality of the introduced foreign banks.

4.5 Establish and perfect financial security early warning mechanism

A country's financial and economic crisis has its own profound historical background, and there would be some signs before the outbreak of the crisis. So analyze the economic and financial status comprehensively and take appropriate method of quantitative will often be able to predict the financial crisis in advance. As early as September 1995 and September 1996, the famous Chinese economist, Professor Liu Zunyi has clearly stated in the international conference that "next Mexico will be Southeast Asia" which predicted accurately the Asian financial crisis.²⁷ Although the scholars in Southeast Asia disagreed with the view, but history is merciless, the Asian financial crisis erupted in 1997 fully proved that financial crisis can be recognized and

²⁷ WANG Tong, 《Who can predict the Asian financial crisis》, 《Listed Companies》 1998, Journal 12

predicted. People's Bank of China, as the supreme "guardian" of financial security in the situation of China's opening up, it applied econometrics, fuzzy comprehensive evaluation method, method of planning and balanced quantitative analysis and all other analysis method based on economic and financial data to study the situation of China's economic and financial opening up, strengthen the prediction and monitoring of financial crisis and financial security symptom under the situation of opening up, thereby could find out problems earlier and take preventive measures. We thought that strengthening the prediction and monitoring can be achieved through the establishment and perfection of financial security early warning mechanism, the establishment of financial security and financial crisis determine indicator system and conduct analysis of each indicators system to judge the degree of financial security. Except for equity participation proportion of foreign banks, market share, the proportion of foreign country, regional distribution of foreign banks in China, etc, this indicator system should also include the following economic and financial indicators:

- Actual growth rate of GTP. Continuous declining of this indicator indicate the country's economic basis is vulnerable.
- The relative rate of inflation. Rising of the index shows increasing economic damage.
- Domestic savings rate. The lower the index, the higher dependence on foreign capital, and conversely, the higher the index, the lower dependence on foreign capital.
- Effective exchange rate. Continuous depreciating of the effective exchange rate is a dangerous signal shows over-valued of domestic currency.
- Interest rate. Higher interest rates associated with lower economic growth rate suggests that there may be potential economic risk.
- Domestic and foreign interest rate differential. If domestic interest rates excessively higher than the international interest rates, it means that domestic currency may be overvalued; if interest rate differential rise up, it means that interest rate has become the protection tool for the overvalued exchange rate.
- Status of international trade balance. Long time trade deficit shows overvalue of exchange rate or their non-equilibrium position in the international economy.

- Current account balance. Long time current account deficit indicates poor national economy.
- Structure of foreign investment. Short-term of foreign capital inflow means structural vulnerability and increasing risks.²⁸

4.6 Perfect relevant legal system

The regulatory system on the running of China's financial sector consists of three levels: first is the financial laws enacted by the legislative authorities; second is the financial administrative regulations issued by the state executive authorities; this is financial regulations promulgated by financial supervisory authorities. The real financial legislation started in 1995. The commonly practiced before are various regulations and provisional regulations, measures and notifications, etc. As the policymakers are different, and their point of views are also diversified greatly, therefore, these laws and regulations are often inconsistent with each other and possessed with a strong compartmentalization and administration color, and there are big defects in the authority, stability, continuity and transparency of these laws and regulations. As a result, it is necessary to further clear up and perfect the existing financial laws and regulations to provide a legal basis for the guidance of the opening up of banking sector.

4.6.1 Improve regulatory legislation

The opening up of China's banking sector has been 27 years, but so far has not yet issued a complete set of "Law of foreign banks". Although some management regulations on foreign financial institutions have been promulgated during this period, but the complete supervisory laws and regulations system on foreign financial institutions are far from the establishment which is bad for the overall management on the business activities of foreign banks in China. Therefore, now we must strengthen the legislation, and perfect the supervisory laws and regulations system as soon as possible: first, we should enact "Law of foreign banks" regulating basic legal relations between foreign banks, improve the legislation level and enhance the stability of laws;

²⁸ WANG Yuanlong, 《China, opening up and financial security》

second, on the basis of the establishment and implementation of basic law, formulate a complete set of auxiliary special laws, such as “Foreign Bank Supervision Law”, “Law on Market Exit of Foreign Banks”; Third, try to avoid issuing excessive administrative documents or internal notice, we should strengthen the construction of laws and regulations to increase the seriousness of law enforcement by regulatory authorities. Only in this way could we institutionalize and standardize the supervision on foreign banks, so as to ensure the healthy development of foreign banks and no infringement on China’s legitimate interests.

4.6.2 Improve market legislation

Perfect relevant auxiliary market legal system and fight a good fight in M &A and anti-war mergers and acquisitions. First is about antitrust and competition restriction. Developed countries have all along attached great importance to anti-trust issue, especially in the financial field. “Bank of Holding Company Act” of the United States expressly stipulated in section III that the Federal Reserve Board must consider the following actors when reviewing the application of foreign banks or holding companies for acquire of shares or assets in domestic banks: the impact on the competition and concentration of resources in the United States; convenience and needs of the community serviced by the acquired banks; information disclosure and the regulatory system in the home country; financial capacity and management ability of the applying company or bank; anti-money laundering. In contrast, China’s “Administrative Measures” only taking into account the assets and management of foreign investors, but lack of attention to antitrust, competition restrictions, and other issues. In this respect, except for the promulgation of “Antitrust Law” as soon as possible to make up for gaps in relevant legislation, we should also set up clear restrictions on the numbers and requirements of foreign equity participation in homogenous banks, the equity participation acts which is not conducive to fair competition and may threaten the interests of depositors should be strictly restricted.

Conclusions

With the accelerating process of economic globalization, the trend of financial globalization has been further strengthened. Since December 11, 2001, the date of China's accession to the WTO, the process of Chinese financial reform and financial internationalization has been greatly accelerated, and the opening up of the banking sector has become an irreversible trend. The opening up of banking sector, the introduction of foreign capital and advanced international management technology have played an active role in promoting the reform of banking sector and fair competition. During more than two decades after the entering of foreign financial institutions into China, it not only promoted the market competition of China's financial industry, brought diversification of financial products and improved services efficiency, but also brought the running concept of modern banks and advanced management method, promoted the commercialization process of domestic banking sector. However, finance is the core and nerve center of the national economy, and China's financial industry is still infant industry, the reason why the western powers find excuses again and again to urge China to open its financial market is to take the name of "free market" to conduct "free invasion"²⁹, and conduct financial "plunder" in China whose financial industry is relatively weak, and ultimately obtain the control of the banks and financial industry, and even the overall national economy and politics. Under this objective conditions, how to achieve "protecting while opening, opening while protecting" in the opening up to foreign banks, and to prevent the bad situation that foreign banks pressed hard and Chinese banks retreated one step after another, and safeguard China's economic interests, financial stability, and guarantee Chinese financial security and economic security. This required us to handle the relationships between the opening of banking sector and safeguard of financial security properly.

The opening up promoted the development of the internationalization of Chinese economy, and the improvement of external dependence indicates that the levels of the

²⁹ October 22th, 1998, 《People's Daily》, "Economic globalization call for financial security"

utilization of international resources and international market by China have been greatly improved, and the ability of China's participation in the international division of labor and international competition has been further enhanced, thereby played an extremely important role in improving the overall levels of China's national economy. But no doubt, with the development of economic internationalization and improvement of external dependence, the risks for Chinese economy and financial have also increasing day by day, and the requirements to maintain financial security become more and higher. The following aspects should be paid attention to while dealing with the relationship between opening up and financial security:

- China's opening up policy cannot be changed. The opening up is a fundamental state policy in China, with the purpose of promoting the development of productivity. Deng Xiaoping has revealed the relationship between the opening up and the development of productivity by emphasized repeatedly: "in order to develop the productivity, we must conduct reform of China's economic system, and carry out the opening-up policy. We attract the capitals and technologies of capitalist countries so as to develop the socialist productive forces in China". International economic and technological exchanges is the objective requirements of mass production, without the external conditions, China's socialist modernization is impossible to achieve. Because "Open to the outside world have important sense, any countries want to develop by isolating itself and closing the country to international communication is impossible, refuse to strengthen international exchanges and introduce the advanced experience, science and technology and capital is impossible"(October 22, 1998 "People's Daily" "Economic globalization calls for financial security"). The opening up is the irreversible trend, so the opening up policy shouldn't be sway slightly. Opening up will cause risks definitely, however, it is one-sided to blame the Asian financial crisis to the opening up, China can't, and will never try to avoid risks by "close-door".
- Expand the opening up and maintenance of financial security complements each other. Expanding the opening up and maintaining financial security is not the fish

and bear's paw, there is relation of unity of opposites between them. The amount of financial risks change in direct proportion with the external dependence level of the country, but it doesn't mean that high risks will definitely caused financial crisis and low risks will not lead to financial crisis. During the Asian financial crisis, the impacts suffered by Hong Kong and Singapore, whose openness of economy is relatively higher, are far less than those in the countries or regions with relatively low degree of openness, the key reason is they have relatively sound and perfect risk prevention and control mechanism. The expansion of the opening up requires a sound and healthy financial system so as to maintain financial security, while financial security is an important guarantee for the expansion of opening up.

- Maintain financial security should be compatible with the opening up. To see from the actual situation of China's economic development, China's economic internationalization process showed relatively advance in quantity, but in quality, that is the improvement of the overall structure and competitiveness seemed more lag, especially the capability of financial regulation is far behind the requirement of the development of the opening up. Obviously, this situation is not conducive to maintaining financial security. It must be pointed out that only the opening up on the basis of financial security can be a real and effective opening up; and conversely, the opening up on the basis of financial insecurity is not only ineffective, but also will intensify financial insecurity. Therefore, China should look ahead properly in the aspect of maintaining financial security, for example, to speed up the improvement and perfection of the financial system, strengthen financial regulation, while in the aspect of the opening up of the capital markets and financial services, we should do according to our own abilities and carry it out step by step, and maintain proper scale and rational structure on the usage of foreign capital. We must plan ahead, and speed up building financial security defense.³⁰

³⁰ WANG Yuanlong, 《China, opening up and financial security》

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Curriculum Vitae

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Zusammenfassung

Die Umsetzung der China Foreign Regulations am 11.12.2006 symbolisiert den Beitritt China in die WTO. Die internationale Gemeinschaft über den Handel mit Finanzdienstleistungen zu Ehren der Verpfändung zeigt die internationale Eröffnung der chinesischen Banken. Diese Eröffnung bringt China nicht nur Kapital und fortschrittliche Management-Konzepte, Produkte und Technologien und fördert die Vertiefung und der Reform der Finanzmärkte. Sie verstärkt auch das Bewusstsein des Wettbewerbs auf dem Finanzmarkt und fördert die finanzielle Stabilität, Effizienz und Betriebe Chinas. Dadurch ragt das Finanzsicherheitsproblem heraus.

China sollte durch die Öffnung die Gelegenheit ausnützen, den Wettbewerb auf dem Finanzmarkt zu fördern, Diversifikation von Finanzprodukten und Dienstleistung zu erhöhen, die chinesische Bankmanagement-Konzepte auszubessern, Kommerzialisierung der inländischen Banken zu fördern. Das Ziel ist, die Wettbewerbsfähigkeit der inländischen Banken zu stärken und das Wirtschaftswachstum effizient zu unterstützen.