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Banking on Africa: Chinese Financial Institutions and Africa

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African perspectives. Global insights.

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ABOUT THE CHINA IN AFRICA PROJECT

SAIIA's 'China in Africa' research project investigates the emerging relationship between China and Africa; analyses China's trade and foreign policy towards the continent; and studies the implications of this strategic co-operation in the political, military, economic and diplomatic fields.

The project seeks to develop an understanding of the motives, rationale and institutional structures guiding China's Africa policy, and to study China's growing power and influence so that they will help rather than hinder development in Africa. It further aims to assist African policymakers to recognise the opportunities presented by the Chinese commitment to the continent, and presents a platform for broad discussion about how to facilitate closer co-operation. The key objective is to produce policy-relevant research that will allow Africa to reap the benefits of interaction with China, so that a collective and integrated African response to future challenges can be devised that provides for constructive engagement with Chinese partners.

A 'China-Africa Toolkit' is being developed to serve African policymakers as an information database, a source of capacity building and a guide to policy formulation.

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ABSTRACT

The Chinese drive into the resource sector in Africa has already received much attention in the media and, increasingly, in scholarly literature. What has not been well understood is the role of Chinese financial institutions in support of the country's resource strategy and, increasingly, their entry into the previously unknown African market. With the Industrial and Commercial Bank of China's purchase of a 20% stake in one of South Africa's leading banks in late 2007, the stage has been set for a new phase of China's engagement on the continent that promises to expand the sectoral reach of Chinese financial institutions and, concurrently, lay the foundation for ventures into new areas like commercial and, perhaps, retail banking. This paper will outline the origins of China's financial institutions; their reform and expansion beyond the domestic market; the role they have played in support of China's resource strategy towards Africa; and, finally, the nascent movement into commercial banking in Africa, including its modalities and implications.

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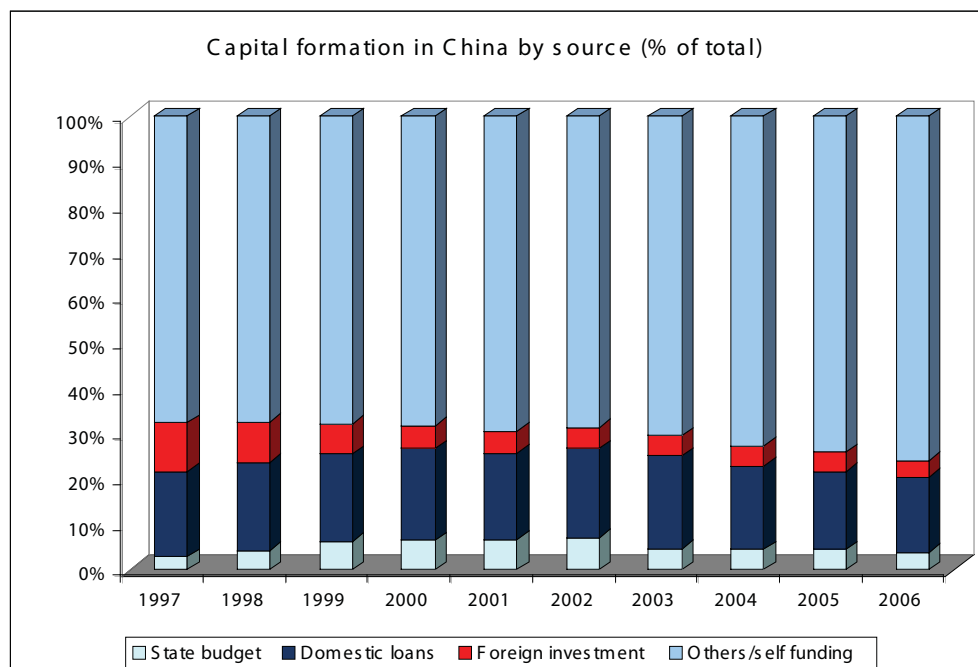
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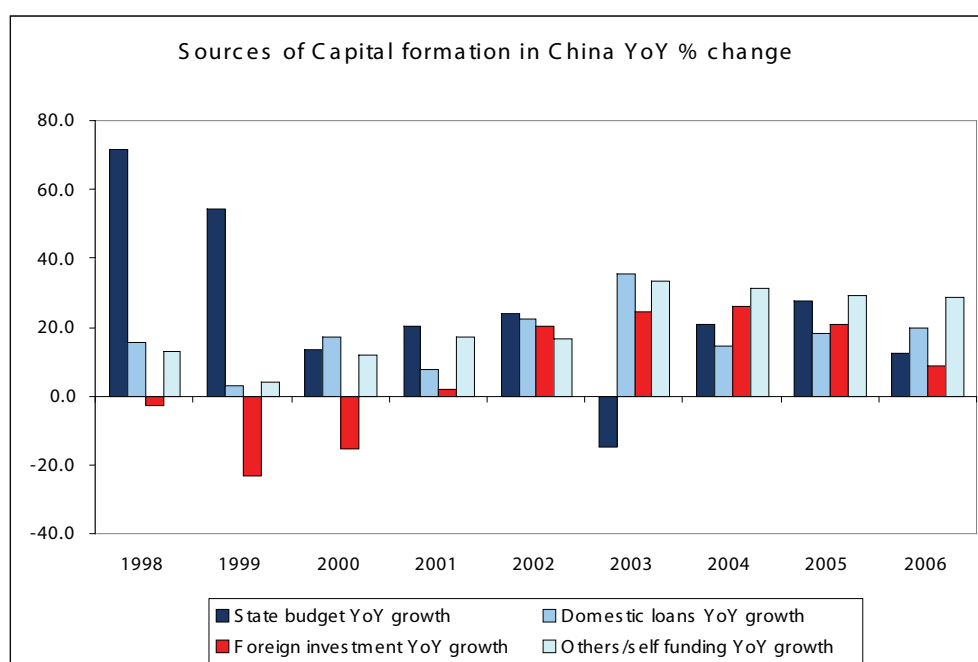
ORIGINS OF CHINA'S FINANCIAL SECTOR, ITS REFORM AND THE RISE OF 'FINANCIAL CHAMPIONS'

Ever since the launch of the 'opening and reform' policy in 1978, China has been a major and consistent recipient of foreign direct investment (FDI). The rapid rise in FDI has made for a considerable increase in the Chinese capital account. FDI bound for China now accounts for about 40% of all FDI destined for developing economies. But the cost of such investment can be considerable. The People's Bank of China (PBOC), China's central bank, has had to sterilise the influx of such capital or 'mop up' the increased liquidity that results from its flow into the economy. For this reason, it requires the state banks to repurchase government bonds at interest rates that are lower than those earned on reserve holdings.¹ Since the majority of savings in China are held with the state-owned banks, returns on savings have been low. Gross domestic savings in China have surged since 2000, climbing to over 50% of gross domestic product (GDP) in 2005. Enterprise savings have risen sharply and displaced household savings as the main contributor to national savings. However, while household savings have declined as a percentage of GDP, this is mainly because of a huge increase in the share of enterprise income in national income.² As can be seen from the two charts in figure 1, capital formation is increasingly driven by self funding, meaning that domestic corporations are increasingly using earnings to drive investment. It is also noteworthy that foreign investment, while very high in absolute terms, is declining in relative terms as a driver of capital formation.

Figure 1: Capital formation in China and its sources, 1997/1998–2006



Source: National Bureau of Statistics of China.



Note: Year-on-Year (YoY)

Source: National Bureau of Statistics of China.

The rapid rise in investment over the last few years has given rise to concerns over the easy availability of credit. This means that an accumulation of excess capacity is a real concern (the trend in consumption as a percentage of GDP versus gross capital formation is in favour of the latter). This could hamper the government's efforts in further reducing non-performing loans at state-owned banks through the formation of asset management companies in 1998 and the subsequent recapitalisation of a number of banks.

With most savings tied up in state-owned banks, coupled with the spectre of overcapacity in certain sectors, the returns on domestic savings are potentially quite low, and in some cases negative. This inefficient allocation of capital is undoubtedly a matter of concern for policymakers. The reform of financial institutions and the investments of foreign banks in China are aimed at leading to better credit assessment and better allocation of capital. In addition, the development of capital markets will likely contribute to better credit discipline, and in this regard, China has a considerable way to go. Reflecting this, by the end 2006, only 6% of bonds, including commercial paper, were issued by non-financial enterprises (including state-owned enterprises – SOEs). This makes it the least developed bond market in Asia. The majority of loans at the bigger state banks are still extended to SOEs, and traditionally the government has relied on SOEs to provide employment and pension and health benefits in the absence of a comprehensive social security system, a system that is changing as the state takes on more of these social benefits costs from SOEs.³ With the opening of the banking sector to foreign participants in 2006 and the increasing number of foreign banks taking stakes in Chinese banks, the aim is to rely on foreign banks to bring better credit assessment and banking system technology that will bring about better lending and hence better return on savings.⁴

Against this backdrop of change and reform, the main challenges that Chinese policymakers face in the financial sectors are twofold: the need to liberalise the capital account

and gradually eliminate foreign exchange control, and the need to prevent a flight of capital from China to overseas investments that will bring higher returns.

Reform of China's financial institutional structure

The catalyst for this institutional reform was the creation of four state-owned commercial banks from PBOC, the country's central bank, in 1984. Up until this time the Chinese banks operated as little more than cashiers for government, without even the fundamental lending or depositing functions one associates with a modern bank.

The first step was the spinning off of three commercial banks from PBOC, with each designated to act as specialist conduits for the channelling of government capital to the key agricultural, industrial and construction sectors. With the fourth bank, PBOC itself, taking on the mantle of central bank (or cashier), the other three banks were named the Agricultural Bank of China, the Industrial and Commercial Bank of China (ICBC), and the Construction Bank of China (CBC). Two state-controlled banks, China ExIm Bank and China Development Bank (CDB), were also established in 1994 out of PBOC, the former institution a reflection of the needs of Chinese companies operating abroad, and anticipating the 'going out' strategy, and the latter, the leading development infrastructure financier domestically. In addition, the authorities wanted to stimulate further competition in the commercial banking sector and founded two further institutions, China Everbright Bank and Hua Xin Bank in 1992. Finally, in 1996 China Minsheng Bank was formed, but, unlike the other two national banks, its shareholders were mostly private enterprises rather than regional and national governments.⁵

The next milestone was reached with the introduction of the Commercial Bank Law and the Central Bank Law in 1995.⁶ The former laid out the route map for the banks to become operationally stand-alone institutions, managed at arms length from the government and subject to the same pressures and market discipline as western institutions. In order to facilitate this development, major banks were invited to act as strategic investors and consultants to these companies, helping them instil western management techniques, commercial acumen and banking technology.

The culmination of this process was to take place a decade later in October 2006 with the listing of ICBC on both the Hong Kong and Shanghai stock exchanges. This ranked as the world's largest ever initial public offering at \$21.9 billion (surpassing Japan's NTT DoComomo listing in 1998 by over \$3 billion) and also as the first simultaneous listing on these two exchanges. Today, ICBC ranks as the world's fifth-largest bank, while the remaining three banks have followed suit and listed on major exchanges. As at March 2007 global investors showed a voracious appetite for China's state banks, investing \$42.3 billion.⁷ Ironically, given the rise in foreign reserves and corporate profits, and high consumer savings, China's banks will likely not use the windfall from initial public offerings in the domestic economy, as this could lead to a credit bubble and in time to come a surge in non-performing loans. The initial move outwards was tentative and cautious, with CBC acquiring the Hong Kong and Macau retail assets of the Bank of America for \$1.2 billion.⁸ Bank of China soon followed by buying Singapore Aircraft Leasing Enterprise for \$965 million, thereby giving it access to Asia's rapidly growing airline market.

Institutional rationale for China to attract western banks

By nurturing these banks with the assistance of western banks and then listing them on a major international exchange (Hong Kong), China has sent out a clear message about its financial institutional framework, namely that it expects and welcomes co-operation and competition from western institutions so as to galvanise its own domestic players. Indeed, many western banks have already gained a strong foothold in China through their strategic investor relationships (see table 1).

Table 1: Largest foreign bank activity in China

Bank	Size of bank at end 2004 (RMB)	Strategic partner	Strategic involvement
Commercial Bank of China	5.59 trillion (rank 1)	Goldman Sachs, Allianz & American Express	Co-operation in Treasury operations, risk management, human resources, corporate governance & asset management
Bank of China	4.27 trillion (rank 2)	Temasek	Co-operation in restructuring
Construction Bank of China	3.91 trillion (rank 3)	Bank of America	Co-operation in risk management, technology & IT, finance, corporate governance & management
Bank of Communications	3.14 trillion (rank 5)	HSBC	Credit cards
Huaxia Bank	Unknown	Deutsche Bank & Royal Bank of Scotland	Co-operation in credit card development & insurance
Bank of Beijing	Unknown	ING	Co-operation in retail banking

In order to entice strategic investors, it is necessary for these Chinese firms to be as audit-able and transparent as any other potential recipient of capital in any other market in the world, and hence this implies the need for comparable regulatory, accounting, governance, training and auditing frameworks. Thus, the big four audit firms (KPMG, PWC, Accenture and Deloitte) have been encouraged to bid for audit assignments at the major banks in China, and an intensive programme of regulatory reform has been initiated. With the creation of PBOC⁹ as the country's central bank in 1995 with responsibility for monetary policy,¹⁰ bond trading, clearing and settlement, the reform programme brought China's economic institutions into closer alignment with the major western economies. Foreign exchange administration was transferred to the State Administration of Foreign Exchange. The China Banking Regulatory Commission (CRBC) was created in 2003 with the aim of reforming bank oversight and 'the regulation and supervision of banks, asset management

companies, trust and investment companies as well as other deposit-taking financial institutions. Its mission is to maintain a safe and sound banking system in China'.¹¹

Clearly, just as in other sectors where the government has indentified corporations (usually former SOEs) to lead the charge to establish a presence in international markets with world-class products, the move into the financial sector will likely be led by the biggest banks: Bank of China, CBC, ICBC and possibly CDB. The case of the latter is not as clear cut yet, since it has been operating as a policy bank and implementing a substantial part of the development policy of the state (such as the Three Gorges Dam and Shanghai Pudong International Airport projects) in the inner provinces of China and in projects involving the receipt of aid. The state has injected \$20 billion into CDB, and the bank has become more active in foreign acquisitions, including taking a stake in Barclays and entering a co-operative venture with Nigeria's United Bank for Africa.¹²

The desire of China to establish multinational corporations (MNCs) in international markets is clear and not far removed from the Korean *chaebol* model and the activities of Japanese MNCs preceding it. What matters for the banks is the timing of forays into foreign markets. As will be argued, the Chinese banks appeared to be proceeding according to the 'follow your client' model, but there is a clear paradigm shift under way in the form of the 'credit crunch' and the significant impact it will have on western banks. With substantially reduced liquidity, western banks are no longer able to offer the terms of finance that spurred a global lending spree in the last few years and have even turned to the cash-flush Chinese for assistance. The onset of Chinese-financed purchases of shares in traditional western banking stalwarts, for instance Morgan Stanley, is a demonstration of this new set of circumstances. Thus the opportunities for China to establish a more formidable presence internationally and in emerging markets is becoming more pressing and it is the large Chinese banks that will likely lead the charge.

THE ROLE OF FINANCE IN SUPPORTING THE CHINESE GOVERNMENT'S AMBITIONS TO ACQUIRE RESOURCES AND MARKET SHARE IN AFRICA

The case for China's rapid expansion of trade relations with Africa, amounting to \$72 billion at the end of 2007, is firstly premised on the need for resource security to ensure the continued rapid economic development of the country. This is clearly illustrated in the identity of China's biggest trade partners on the continent: Sudan, Angola, Nigeria and South Africa. But the need to secure resources is based on the need of Chinese companies to secure the commodities through a variety of formats, including joint ventures with local firms, such as the agreement between Gabon's national mining company and CMEEC to exploit the iron ore reserves in Belinga; and bids for concessions that are carried out exclusively by the Chinese firms, for instance, the Chambishi copper mine in Zambia; or taking stakes in existing projects such as a 45% stake in an offshore Nigerian oilfield by CNOOC.¹³

In exchange for access to resources, the Chinese state has encouraged a number of ancillary services to develop in the host countries as it builds necessary infrastructure such as railroad and highway extensions. China ExIm Bank and CDB have been playing an important role in the pre-export, trade and project finance for a number of these

projects. While the details of the terms of the financing are not available, one can assume that a great number, if not the majority, were priced on favourable terms for the recipient countries and likely function more as an extension of Chinese aid. In some cases, however, China has started co-operating with western banks to do project finance deals. This includes the Sinopec (China Petrochemical Corporation) financing for its joint venture with Angola's Sonangol for offshore block 18. Initially attracting little participation from western banks,¹⁴ the deal later attracted a range of western and Chinese banks, and the political risk of operating in Angola was seen to have been mitigated by the size of the Chinese participation.

The investment of Chinese firms in Africa, with its tie-ins of resource supply agreements in exchange for Chinese-sponsored infrastructure development, has been controversial precisely because it is so vastly different from western investment and aid. The investment is not mired in procedures and there are few conditions attached to such lending.¹⁵ In the case of Angola, Sudan and Nigeria, the guarantees of oil supplies in exchange for infrastructure lending and construction have involved importing Chinese workers to work on construction projects. The fact that tens of thousands of Chinese labourers are entering these countries, sometimes employed at wages that are below host governments' national legal standards and in some cases subject to conditions that at least nominally break with safety regulations, is significant. But while most accounts have focused on the social implications of this influx, there are some interesting implications from the perspective of the financial sector.

Chinese migrants in Africa

It is this rise in the number of Chinese labours and, following in their wake, a growing migrant population that has swelled the Chinese population in African countries officially to three-quarters of a million (but in fact it is likely to have exceeded this figure), that holds significance for Chinese financial institutions. In the first instance, a striking feature of the Chinese employed in Africa is the fact that they are less skilled and generally poorer than would be the average migrant from inner China to the fast-developing coastal regions of that country. This was evident in interviews with a number of Chinese entrepreneurs and workers in South Africa, to date the largest recipient of Chinese migration to the African continent, where a common theme emerged: Africa was seen by many to be a money-making opportunity as compared to China. In fact, it was argued by some interviewees that competition for jobs in China was very intense and that education and age were determining factors in securing good positions. In contrast, able to use superior supply chains based in China and import consumer goods at competitive prices, Africa is seen as being far less competitive and providing attractive trading opportunities. Traditionally, networks are of fundamental importance in Chinese society and the sourcing of workers to come to Africa is not much different: families and friends come in numbers on news of attractive opportunities. The overriding expectation is that, like previous outward migrations from China to other parts of the world, the presence and experience of Chinese labourers will ultimately encourage other Chinese to migrate to Africa.

While this migratory phase can be seen to be pretty much in its infancy, one can assume that it may accelerate, and, given the likely oversupply of labour in some sectors in China, an economic slowdown in that country may send more skilled and unskilled labour abroad. Of note is the construction sector in China, which has been one of the

major factors in development over the last decade. However, in a number of provinces this sector is seen as a bubble that has led to complete oversupply. In this regard, Africa has a lot to offer China, as the continent's infrastructure is underdeveloped and the construction sector can develop quickly as economic activity expands in countries that can take advantage of the economic boom. Moreover, the speed and efficiency with which these projects come to fruition can be attributed to the ease of communication and understanding of deliverables between the Chinese management and Chinese workers.

In addition, Africa can also be a partial solution to another unique Chinese conundrum: excessive foreign reserves. Given the significant investment in China, the Chinese central bank has the unique (perhaps enviable position) of 'sterilising' the inflow through government bond issuance. Controls on overseas investment and the inconvertibility of the renmibi are at the heart of this problem. Both policies at some point will come to an end. More extensive investment abroad, as with the setting up of the China Investment Corporation (CIC), has led to a growing presence in investment in the financial industry. CIC has made two significant investments in the sector: in one it put more than \$3 billion into a private equity fund set up by JC Flowers & Co of New York aimed at selective investment in financial institutions.¹⁶ Given the scramble for fresh capital by western financial institutions, it can be safely assumed that further sovereign fund investment will follow. While this presents a valuable outlet for China's excess cash, it should be noted that the sovereign funds are almost always silent investors with no participation in management, even though they get seats on the boards of the companies in which investments are made. The sovereign fund investment model may well be appropriate for investment in the West, where political opposition may be significant and a more active investment profile in the financial sector may not be in the immediate offing. Africa and other emerging markets present a different opportunity.

Chinese financial institutions enter the African market

China ExIm Bank has traditionally been the leading Chinese financial institution working in Africa, focusing the bulk of its attention on providing export finance, credit lines and participation in project finance. CDB, by contrast, has been charged with lending to the domestic market, admittedly an enormous challenge in itself. But it has also been providing finance for corporations and has made overseas investments, including buying a stake in Barclays and lately in Polish telecoms, and has been involved in key deals in Africa, with its co-operation with Nigerian United Bank for Africa being a key conduit for financing. CDB, the country's largest policy lender, has secured formal approval from the State Council to establish a new firm,¹⁷ which will be called China Development Bank Corporation. The expectation is that even though it will venture into retail and commercial banking activities, the focus of its business will remain national development projects and some degree of overseas expansion. Notably, however, there is currently an investigation into the vice president of the bank, Wang Yi, by anti-corruption authorities.¹⁸ This may just be limited to this particular official, but has the potential to affect CDB's standing and subsequent overseas involvement. Moreover, it points to one of the key mechanisms by which the Chinese state – despite the abovementioned decentralisation, modernisation and privatisation of much of the economic system since 1978 – continues to exercise influence over these institutions.

CDB will also continue to play an important role in concert with China ExIm Bank

through investment in the \$5 billion China–Africa Development Fund. According to the draft plan, the fund will start at \$1 billion, and then increase up to \$3 billion in the second phase, eventually amounting to \$5 billion. The fund will be used to support African countries' agriculture, manufacturing and energy sectors, transportation, telecommunications, urban infrastructure and resource exploration, as well as the development of Chinese enterprises in Africa.¹⁹ The fund signed its first deals with four Chinese companies – CGC Overseas Construction, Sinosteel, Shenzhen Energy Investment and China National Building Material – in Beijing in January 2008²⁰ to invest in various infrastructure and housing projects in Africa. It is interesting to note that the Chinese media referred to this as a private equity fund, but one that does not pursue the same rates of return as western private equity funds, instead pursuing social development concerns.

This implies that the Chinese government does not see a dichotomy between social development and investment returns. However, it should be pointed out that if Chinese companies do employ a majority of Chinese workers and suppliers, the cost base can remain low, time overruns are unlikely and hence the hurdle rate (the minimum projected return on an investment that has to be matched before the deal is approved) could well be below what any western financial institution could imagine. If this is indeed the case, then much more investment and commercial banking participation in such projects seem not far off, especially since western banks may apply higher weightings to country risk and project risk, as their strategic interest may not be as fundamental as that of China, i.e. securing resources through exports. By controlling the inputs to the project – or a large part thereof – and ensuring the timeliness of delivery, there is indeed a degree of risk transfer from the bank to the companies that win such projects.

Investing abroad: How do banks decide?

The decision to invest in foreign markets therefore becomes a more elementary one than is usually the case. A considerable number of studies have centred on the investment decision in emerging markets, usually from the point of view of banks in developed countries. Relatively few studies have focused on the investment decisions of developing country banks in other developing countries. Nevertheless, the drivers of investment by banks are usually similar. The most important is diversification, as banks are highly susceptible to earnings volatility in business cycles. Shareholders of large international banks indeed seem to prefer earnings diversification to ensure earnings stability. Two other important factors that point to the decision to invest abroad²¹ are a higher expected rate of GDP growth and investing in countries where the banking system is less efficient. Other studies have gone even further and concluded that foreign banks invest in regions where banking regulation is weaker.²² One possible explanation offered is that heavily regulated markets may be less accessible to foreign players and that a larger degree of protection exists for domestic players. Given the premise that the foreign bank has more efficient banking systems in place and superior risk management systems, as well as access to product solutions, the entry of foreign banks brings immediate improvements in efficiency.²³

But other factors are equally as important in determining where to invest. The studies cited indicated that proximity is an important factor, and this not only refers to geographical proximity, but also to proximity in terms of cultural, linguistic and economic ties. These factors seem to militate against a Chinese banking foray into Africa, given the dearth of any such ties. Hence, what this could point to is a new forging of ties between

non-western powers, borne out of economic necessity (or, as proponents prefer to characterise it, 'mutual benefit'). Since China has no colonial baggage that renders – at least until recently – its economic decisions subject to political controversy in Africa, it could well be in an advantageous position to exploit opportunities. Moreover, its risk appetite may be far more voracious than that of its western counterparts, since its shareholders (apart from the publicly listed shares) are mostly government departments that subscribe to a political agenda rather than requiring immediate shareholder return. Moreover, as pointed out above, the hurdle rate for investment projects may be lower, especially where Chinese companies are involved.

However, this does not mean that financial returns do not feature as a factor. In fact, as Chinese banks expand overseas, they will act more in line with their competitors. Before Chinese financial institutions start acting competitively in the international arena, they will need to enhance their competitive capabilities. This will involve acquiring payment and processing systems to handle international transfers, data-capturing systems, and management information systems to process such data. Crucially, operational and credit risk systems will need to be enhanced. One can argue that one of the main aims of the Chinese government in opening the banking system to foreign investment is to gain the necessary expertise to become highly competitive. In local markets, and especially emerging markets, local banks may well have an advantage in market information, given superior access to corporations, superior relationships and a better understanding of local market conditions. This implies that a foreign bank with little experience in entering foreign markets will need to take a cautious approach. This is likely to start with a fundamental understanding of the key players in the local market and to approach such institutions with an understanding to co-operate, start joint ventures and eventually make equity investments.

ICBC's investment in Standard Bank

The investment world was surprised in October 2007 when it was announced that ICBC would take a 20% stake in South Africa's Standard Bank for \$5.5 billion. This was a significant outlay, even for ICBC, as the finance allocated to the deal equates to 8% of its capital. The reasoning seems sound from a strategic point of view: ostensibly Standard Bank will help ICBC serve its corporate customers in Africa, while Standard Bank will gain a foothold in China. Moreover, given its global expansion plans, Standard Bank will use the capital for expansion into the rest of Africa and the developing world. Of this investment, \$450 million of capital is earmarked to support organic African growth. Key to this is that Standard Bank plans to substantially increase its Nigerian retail network of around 56 branches and add 200 ATMs this year.²⁴

Standard Bank is an appealing partner for ICBC in large measure because it has operations in 18 African countries; has a market capitalisation of ZAR146 billion in South Africa; and has highly advanced operating systems, management information systems and credit risk policies in place. ICBC is the foremost bank for Chinese SOEs and has a strong national presence. It has also set up a strategy department (initially with 20 staff) to map the bank's expansion policy and oversee mergers and acquisitions.²⁵ Of the total investment, Standard Bank has indicated the usage as follows: \$450 million will be utilised in Africa, \$400 million is earmarked for growth in South Africa, \$300 million will be set aside for international activities and \$200 million will be contributed towards

the global resources fund to be established by Standard Bank and ICBC. A further \$200 million will be set aside for private equity investments. The largest portion, \$900 million, has been earmarked as strategic capital reserves.²⁶ It is apparent from this that Standard Bank will target growth outside its home market and will be well placed to target Chinese corporate customers operating in Africa. This presents it with a significant opportunity to consolidate its operations in Africa and take a large share of business from Chinese clients, who will increasingly be important in this area. Standard Bank operates out of the most advanced banking market in Africa with a well-developed commercial legal system and can determine strategic direction for Africa from its Johannesburg base, deploy resources effectively and continue to build on its integrated Africa operations on common platforms. This puts it at a significant advantage compared to many other competitors. Hence, this seems to be the benchmark investment approach for Chinese banks in emerging markets: target the bigger, sophisticated institutions with multicountry presence first.

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In addition SAIIA has 49 corporate members which are mainly drawn from the South African private sector and international businesses with an interest in Africa and a further 53 diplomatic and 11 institutional members.



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