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**CHANGES IN ASIAN BANKING  
INDUSTRY**

-

**COMPARATIVE STUDIES IN  
HONG KONG, SINGAPORE AND  
CHINA**

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## Abstract

Changes in banking industry can be observed from different perspectives, one of which is the phenomenon of mergers and acquisitions (M&As). M&A is a highly abstract and compact concept, especially in the case of banking industry. When it comes to the Asian banking industry, currently impacts of China's WTO entry on its banking industry has become a very hot topic. In our study, we take two acquisitions that came through in Hong Kong to kick off the research. The study of two acquisitions involves looking at the two largest commercial banks, from Singapore and China, operating in Hong Kong, and leads to the comparative study on banking industry in the two freest economies and the largest emerging economy in the world, namely, Hong Kong, Singapore and China.

We are looking for motives and causes for the acquisitions, under the context of the current trend of the world banking industry, and given the sharp differences in size, the structure and regulations of our three target economies. This decides the nature of our studies as being comparative study.

We have found, due to different reasons, that Singapore banks and Chinese banks all feel pressure and are looking for something that cannot be found in their home market. Chinese banks are looking for professionally international banking practice, international network, talented people and capital source. Singapore banks are seeking bigger size in terms of scale and scope, better profitability and promising future markets. Hong Kong, as one of major international financial centers, has offered what they are really looking for. Indeed, this kind of "demanding and supplying" relationship has evolved over time and will bring out further changes and lead to the rise of big players in the industry.

**Key words:** commercial banks, changes, regulations, size and profitability, Hong Kong, Singapore and China.

## Acknowledgement

After three semesters of the Integrated Master Program here comes our thesis: *Changes in Asian Banking Industry-Comparative Studies in Hong Kong, Singapore and China*.

Just like M&As is a concept that brings many aspects together, so our thesis paper is filled with complex contribution. First of all, we would like to take this opportunity to express our warmest Thank You to our tutor at our school, Professor Thomas Polesie. With his valuable advice and comments on our work, we were able to develop our thesis as well as our research learning process. We would also like to thank Håkan Javefors for his help on research methodology. Our classmates Patricia Gonzalez Grigori and Carl Wingmark also gave us kind suggestions, so we would like to extend our thanks to them as well. Last, but not least, many thanks to everyone who ever helped us with our thesis work.

# 1. Introduction

In today's world, globalization and multinational enterprises (MNEs) have greatly influenced our life in every aspect. The research cannot be conducted by only focusing on globalization without studying MNE, and vice versa. MNE is one of the main forces in the world economic development and globalization. As a producer of goods and/or services, MNEs differentiate themselves from purely domestic firms by extending over borders and functioning under more than one national sovereign. Another important characteristic of MNEs is that MNEs make foreign direct investment (FDI), that is, they do more than just export or import; a firm lacking a presence abroad (i.e. a foreign direct investment) is not an MNE (Geaffrey, 1990).

As a producer of banking services, multinational banks (MNBs) share some common features with multinational manufacturing companies. However, a distinction can be made between international banking and multinational banking. International banking includes foreign trade finance and lending to corporations and governments resident in foreign countries. Cross-border lending and trade finance can be-and often is-conducted without such facilities. Multinational banks own and control branches and affiliates in more than one country. They often perform international banking, but the essential question is why such banks move across borders (Geoffrey, 1990).

Modern multinational corporate banks flourished in two waves. British institutions led the first wave from the 1830s. Later in the nineteenth century the British overseas banks were joined by corporate banks from other countries, such as Germany, France and Japan. The nineteenth century was a period of considerable changes and new developments in the world banking. There are some features deserving emphasis. In the nineteenth century branches of multinational banks were overwhelmingly concentrated on developing economies. Banks also established branches in international financial centers, notably London, but foreign penetration of the domestic banking system of Britain, Continental Europe or the United States was virtually non-existent. Nineteenth-century multinational corporate banks operated in a world of diverse institutional and contractual

arrangements. Correspondent or independent agent-type relationships could compete quite well with intrafirm transactions, since the relationship provided profitable means of engaging in international banking without the risks often associated with owning branches abroad.

American banks led the second wave from the 1960s, together with some European and Japanese banks. These 'second wave' multinational banks varied from their nineteenth-century predecessors in their geographical location and the way of conducting banking services. Western Europe, North America and Australia became more attractive places for multinational banks. In addition, in the 1970s the rise of offshore centers and the growth of the Asian Dollar Market led to Singapore and Hong Kong attracting many branches. Most multinational banks did establish and own their branches via foreign direct investment. The most striking example is the United States. The development of American multinational banks can be distinguished into two periods: a 'local' period from 1941 to 1960 and a 'global' one from 1960 onward. In the first, multinational banking was the exception; in the latter it became the rule, in the sense that practically every major US bank had one or more foreign offices and practically every major foreign bank had operations in the United States (Geoffrey, 1990).

It is said that multinational banks often followed its major enterprises customer who had foreign direct investment, but this is not exactly so. Multinational manufacturing, according to Geoffrey (1990), started later in the 1850s and 1860s, and grew in the late nineteenth century, as did their banking equivalents, but there was also a considerable surge in the 1920s which had no clear banking parallel while a further surge began in the mid-1950s; this was some years before the second wave of multinational banks. More strikingly, the vigorous growth of American multinational manufacturing in the second half of the nineteenth century and the interwar years contrasted with the limited American multinational presence around that period of time.

Therefore, there must be other fundamental reasons for explosion of American multinational banks. Thomas (1990) highlighted three reasons for

explaining the ‘two way’ flow of multinational banking (US bank MNEs abroad and non-US bank MNEs into the US). First, since 1960, there was a stable economic growth and stable political regimes, combined with relaxation of exchange controls, reduction of trade barriers and promotion of foreign investment. Secondly, since 1960 countries around the world have opened their markets to entry by foreign banking organizations and removed barriers to expansion by domestic banking organizations into foreign markets. These regulatory changes have facilitated the growth of US banks MNEs and of non-US bank MNEs in the US. (Geoffrey 1990). Finally, ‘microeconomic’ change-the transformation has taken place in the business of banking itself, that is, multinational banks internalized competitive advantages within their foreign branches instead of by co-operating with correspondents or independent agents. Three fundamental forces brought about this trend toward globalization in banking. The first was technology. The second was the rise of institutional investors. The third was financial innovation. Advances in the theory of finance, combined with technology, have made it possible to develop a wide range of new derivative financial instruments, such as options, swaps and futures, and the trade of these new derivatives.

## **1.1 Problem Analysis and the Research Question**

During the first wave, Chinese and Japanese multinational banks dominated Asian banking industry and become truly multinational banks, especially in the case of Japanese banks. Presently, The Asian financial crisis that happened four years ago prompted countries in the region, both directly and indirectly suffered by the crisis, to restructure their banking industry and strengthen banking supervision. On the one hand, some banks, most of multinational banks, are exploiting opportunities to develop new markets.

HSBC has signed a memorandum of understanding to buy Seoul Bank in South Korea, and US investment banks say they have begun to make good profits in Japan as the power of that country’s large securities houses wanes (<http://specials.ft.com/ln/ftsurveys/industry/sc3e26.htm>). On the other, some big and local players also seek the opportunity to take strategic actions

to develop rapidly, even though the motives may differentiate among them. Some examples are:

On April 19, 2000, The Industrial and Commercial Bank of China (ICBC) announced that the bank would acquire from the China Merchant Group more than 239 million shares, or 53.2% of the Union Bank of Hong Kong

On December 14, 2000, the chairman of the Bank of China Group revealed the basic plan for the restructuring. The substance of the Group's restructuring plan is to combine the total assets and liabilities of the ten member banks of the Group. Bank of China Hong Kong Branch, the local branches of seven banks incorporated in Beijing and the two locally incorporated banks will form a new bank, which is incorporated in Hong Kong.

On April 11, 2001, Development of Bank Group Holdings (DBS) in Singapore announced that it would launch a voluntary conditional offer for all shares of Dao Heng Bank Group in Hong Kong.

On May 7, 2001, ICBC announced the restructuring of its Hong Kong operation, which will be accomplished by transferring the assets of ICBC (Hong Kong) to ICBC Asia.

Singapore, as one financial center in Asia, has its main strength in the foreign exchange market, which is the fourth largest one in the world. However, local banks in Singapore are generally small-sized and have Southeast Asia as their traditional market. By acquiring one Hong Kong bank, DBS has become the fourth largest bank in Hong Kong by total assets.

The financial market in China has long been closed to the outside world. China's four big state-owned banks have enjoyed their dominance on local market with over 70% of market share by total assets. ICBC, as the largest one among them, has most of the state-owned corporations as their main customers. It is very unusual for such a large Chinese bank as ICBC to go

beyond borders to make acquisitions in international market. When putting these two banks head-to-head, looking at these two acquisitions, and pondering the background and condition colored by Singapore, Hong Kong and China, we are wondering what and why changes have been taking place in their banking industry. Therefore, the research problem is posed as follows:

***Why did Singapore banks and Chinese banks, such as DBS and ICBC, moved to acquire Hong Kong banks?***

## **1.2 Scope and Limitation**

First of all, the research target is the commercial bank rather than the investment bank. Secondly, analyses are focused more on the industry level. The analyses of the two individual banks could be regarded as the further illustrations and complementary to the industry analyses. The concentration on the industry level is mainly due to the limited access to information and data concerning with individual banks in this study. Thirdly, our discussion is focused more on the market environment, regulatory framework and the government policy but less on banks' functions, such as deposit, credit, risk management and so on.

## **1.3 Purpose of the Thesis**

First of all, we will to try to understand what has happened in the banking industry in Hong Kong, Singapore and China, what are the driving forces for acquiring local banks in Hong Kong. Second, how do we understand globalization? People can look at globalization from different perspectives, such as the emergence of multinational companies, cross-border or domestic consolidations, opening and liberalization of financial markets. And impacts of globalization on both different parts of the world and different industries perhaps have shown different effects. Some countries, such as the US and European countries, and some industries, such as telecom industry and financial service industry, have experienced dynamic changes due to globalization. No can keep it away from. So what about the

Asian picture of globalization? Understanding globalization from the Asian banking industry's perspective is also one of purpose of this paper. Third, the study on banking industry has been concentrated on the EU, and the US, with less attention on Asia. With the advent of a new century, there is, or will be, many changes in Asian banking industry, especially taking into account impacts of Asian financial crisis and China's entry of World Trade Organization (WTO).

## **2. Methodology**

### **2.1 Research Strategy**

According to Yin (1994), there are five research strategies: experiment, survey, archival analysis, history and case study. Merriam (1998) suggests that the case study is designed to gain an in-depth understanding of the situation and meaning for those involved. The interest is in the process rather than the outcome, in context rather than specific variables, in discovery rather than confirmation. Compared to other qualitative research methods, case studies are intensive descriptions and analyses of a single unit or bound systems. However, due to limited access to individual banks, it is impossible for me to conduct intensive descriptions and analyses. Therefore, we have to focus on the industry level rather than the company level. The analyses of individual banks will be a further illustration to complement the industry study. In this sense, the research strategy will rely on archival and historical analysis in banking industry. By reviewing changes of American and European banking industry, we get to know how Asian banks can follow their suits. By studying changes of banking industry, we can find responses from individual banks. Several reasons can be listed here. Firstly, studies only focused on individual bank would lead to the result, which is sometimes contrasting to the reality. For example, so far the research on economies of scale and economies of scope in financial service industry has achieved little progress. There seems to be little or no evidence in support of the importance of economies of scale as a motivation for consolidation. However, an interview made by The G10 report, showed that more than 80% of interviewees indicated that economies of scale were very important

in motivating this type of consolidation. One reason may be due to the backwardness in the econometric studies, making it difficult to achieve reliable estimates of scale economies that can explain the current industry consolidation (The G10 report, 2001). Also a substantial literature on testing the theoretical SCP (structure-conduct-performance) relationship contains too many inconsistencies and contradictions to provide a satisfactory description of the SCP relationship in banking (Gibler, 1984; Osbore and Wendel, 1983).

Secondly, as shown by the nature of banking industry, banks have an impact on all other sectors through lending policies, and on large numbers of individuals through deposit-taking function, further on the general financial and monetary condition of an economy. Charles (1988) and Richard (1986) argued that restriction and control has been the fate of the banking industry in every developed country. Also banking industry has undergone dynamic changes. Based on these premises, it is possible to study banking industry from economic development and from regulation and government policy, and then proceed to detect the responses from individual banks.

Thirdly, the study has much to do with data collection, which will be discussed in the next section.

## **2.2 Research Method**

A study can be qualitative, quantitative or a combination of both. The qualitative method permits an evaluator to study selected issues in depth and in detail. According to Patton (1990), the qualitative method allows fieldwork that is not constrained by predetermined categories of analysis. It facilitates the compiling of in-depth information about a smaller number of people and cases. Therefore, it increases the understanding of the cases and situation studied. The major drawback with the qualitative method is that it reduces possibilities of generalization (Patton 1990). However, some authors such as Merriam (1998) are of the opinion that generalization from the case study can be made.

The quantitative approach, on the other hand, requires the use of standardized measures so that the varying perspectives and experiences of people can be fit into a limited number of predetermined response categories. According to Patton (1990), it becomes possible to measure reactions of many respondents to a limited set of questions, thus facilitating comparison and statistical aggregation of the data. This means that a set of broad generalizable findings can be presented succinctly.

We believe both quantitative and qualitative methods suit our research needs, since both objective and subjective information are needed. By combining these two methods, we are able to obtain necessary in-depth data about the banking industry, which would not have been possible to obtain if we had only relied on one of the methods.

### **2.3 Data Collection-Reliance on Secondary Data**

There are two kinds of data, which can be used in research. Primary data is usually collected by the researcher for a specific project through interviews, surveys and observations. Interviews provide the advantage of giving the researcher the possibility to clarify uncertainties, and consequently avoid misunderstandings and incorrect interpretations. But it is time-consuming and expensive. Surveys are less expensive while run the risk of being misunderstood. Observations are most commonly used to study a particular behavior as it takes place. Obviously, this is not relevant to our study (Mark, Philip and Adrian, 2000). In short, collection of primary data seems to be inappropriate to our study, due to the above reasons.

Secondary data is previously published data not purposely collected for specific research. Secondary data can be found both within an organization and outside it. Common forms of secondary data include books, articles, company material, Internet sources, etc. Different researchers have generated a variety of classifications for secondary data. Documentary secondary data can be used on their own or with other sources of secondary data, in particular for historical research and archival research. Survey-based secondary data refers usually to data collected by questionnaires. Such data

can refer to organizations, people or households. They are made available as compiled data tables or as a computer-readable matrix of raw data for secondary analysis. Multiple source secondary data can be based entirely on documentary or on survey data or can be on amalgam of the two (Mark, Philip and Adrian, 2000). For my study, we intend to use all these three kinds of secondary data in order to generate our research conclusion.

### 2.3.1 Advantages and Disadvantages of Secondary Data

According to Mark, Philip and Adrian (2000), secondary data has these advantages and disadvantages:

- ***Few resource requirement.*** In general, it is much less expensive to use secondary data than to collect the data by the researcher himself. Consequently, the researcher may be able to analyze far larger data sets. The researcher will also have more time to think about theoretical aims and substantive issues as his data will already be collected and subsequently to be able to spend more time and effort in analyzing and interpreting the data.
- ***Unobtrusive.*** The researcher can get his data quickly by collecting secondary data. They are likely to be higher-quality data than could be obtained by collecting our own. Using secondary data within an organization may also have the advantage that, because they have already been collected, they provide an unobtrusive measure.
- ***Longitudinal studies may be feasible.*** For many research projects time constraints mean that secondary data provide the only possibility of understanding longitudinal studies. Comparative research may also be possible if comparable data are available. Researchers may find this to be of particular use for research questions and objectives that require regional or international comparisons.
- ***Permanence of data.*** Unlike data collected by the researcher himself, secondary data generally provide a source of data, which is both permanent and available in a form that may be checked relatively easily by others. This means that the data and the research findings are more open to public scrutiny.

All the advantage is directly related to our research question, objective and methodology, particularly concerned with our internationally comparative study on banking industry in Asia.

The main disadvantage of secondary data is that the data may be collected for a purpose, which does not match researcher's need. Usually to counter this disadvantage, the researcher has to find an alternative source. We feel this issue also has much to do with the assessment of the quality of research, which will be discussed in the following.

### 2.3.2 Reliability and Validity of Research

It is crucial that the data collected is relevant and closely related to the research question, especially since the data often is used for the purpose of creating conclusions and reports on the findings. The level of credibility of the data can be expressed in terms of reliability and validity.

Generally, survey data from large well-known organizations are likely to be reliable and trustworthy. Some documentary data is more difficult to assess as for reliability and validity, partly due to the lack of formal method describing how the data were collected, such as diaries, transcripts of interviews or meetings, and partly due to some organizations, whose records are often inconsistent and inaccurate. Kervin (1999) argues that measurement bias can occur for two reasons: the first one is deliberate or intentional distortion of data. Some managers in companies may in their interests like to make "window-dressing" on their accounting information. The other is the change in the way data are collected.

By bearing these things in mind, we attempt to take following measures to assure the quality of the research: First, data sources are differentiated into several groups. On the top group, there are some large international organizations, such as International Monetary Fund (IMF), the World Bank, and Bank for International Settlement (BIS). They are thought to be of good reputation. Then we come to some large professional firms and banks, such

as Hong Kong and Shanghai Bank Corporation (HSBC), KPMG, Standard Chartered Bank and Morgan Stanley & Co. These organizations are supposed to have their professional standards on information disclosure and analyses. In the middle, there are central banks, such as Hong Kong Monetary Authority (HKMA), Monetary Authority of Singapore (MAS) and People's Bank of China (PBOC). The last group includes individual banks: DBS and ICBC. Probably, for the last two groups, these organizations tend to defend their standings in their interests by disclosing information that would not be so objective as doing of a third party. Therefore, we like to collect information as much as possible from the first two groups. Data from the first two groups tend to be trustworthy and credible. Some data could show different purposes, which may not be in line with our research, but collection of multiple data from different organizations could offset this problem to some extent and show a relatively clear and complete picture of our research targets.

Second, we like to conduct a comparative study for banking industry in Singapore and Hong Kong to show the differences between each other. To China, more attention are paid to the changes before and after its opening of the financial market. The key words here are changes, differences and comparisons. This comparative study can avoid too much secondary data collection, from which biased information may arise.

### **3. Relevant Theories and Literature Review**

#### **3.1 Analyzing the Banking Industry**

##### **3.1.1 The Structure and Performance Relationship**

Industrial economic theory suggests that there is a causal link between market structure and bank conduct and performance. A substantial literature has burgeoned and aimed at testing the theoretical SCP (structure-conduct-performance) relationship. Contemporary approaches to the explanation of the link between market structure and performance have emphasized an alternative 'efficient structure' hypothesis. This postulates that an industry's

result; a positive relationship between bank profits and structure can be attributed to gains made in market shares by more efficient banks.

One of the major problems associated with the structure-performance literature is that it barely takes account of the main forces that influence the institutional nature of banking markets, such as the regulatory framework, sector-ownership and so on. It seems indisputable, however, that the structure of a market influences the way in which banks operate in that market.

The recent study by The G10 Report has shown similarities and differences among North American, European and Japanese banks emerging from the comparison of simple balance sheet ratios.

Table 1 Size and performance of commercial banks  
Unit: USD

Area	Variables (as % of gross income, except for ROE)	< 5bn		5-20bn		20-50bn		> 50bn	
		No	Average	No	Average	No	Average	No	Average
Europe	non-int. income	539	19.2	169	24.6	50	20.2	64	30.8
	opt. cost	543	63.1	183	61.6	55	55.6	63	65.5
	return on equity	559	7.1	185	7.4	48	7.2	58	8.2
North America	non-int. income	266	21.5	97	29.2	29	28.2	19	53.4
	opt. cost	266	60.9	96	59.8	29	55.4	19	67.8
	return on equity	266	11.2	97	13.5	29	13.5	19	14.1
Japan	non-int. income	15	0.4	63	9.2	29	8.9	26	30.0
	opt. cost	17	76.9	63	69.5	29	67.9	26	60.4
	return on equity	17	1.3	63	0.1	29	0.5	26	3.2

Source: The G10 Report, 2001.

The ratio of operating costs to gross income is higher for smaller banks (with total assets below USD 5 billion) and it decreases from over 60% to

around 55% for banks with assets between USD 20 and 50 billion. The largest banks, with assets greater than USD 50 billion, present the highest costs (more than 65% of gross income). This pattern points to the existence of economies of scale up to a certain size, followed by diseconomies for very large banks. However, profitability rises with total assets: for North American banks the return on equity increases from 11% to 14% from the first to the fourth class; for European banks it increases from 7 to 8%. For Japanese banks the picture is more straightforward: the ratio of operating costs to gross income decreases as firms become larger; profitability is low or negative because of the deteriorating economic and financial conditions of the economy in the mid-1990s (The G10 Report, 2001).

### 3.1.2 Size and Concentration

Every banking system, for example in Western Europe, has a group of dominant or 'core banks' which are recognized by both the authorities and the general public. The relative importance of bank assets in relation to gross national product can be analyzed by taking the size of individual economies into consideration. The measurement of deposit banks' assets as a percentage of GNP is used to gauge the degree of financial depth in an economy.

The total banking sector assets can be used as a size measure. The concentration measures show to what extent the largest banking sectors in one country have their assets relative to the whole banking sector. For example in Europe, Italy and France have the most concentrated markets, since each five firms in Italy and France own 55,1% and 63% of total market, respectively in 1988.

It is clear that there appears to be a current preference for large size in many banks within different European countries. The desire to obtain economies of scale and scope appear to be the main driving force behind the trend towards larger-sized conglomeration movement (Molyneux, 1988).

### 3.1.3 Performance and Ownership Characteristics of the Largest Banks

The relative performance of industrial countries' banking systems can be gauged by the distinguishing characteristics of the major banks that operate in these markets. It is also the case that the degree of change in market size, concentration and ownership resulting from major reforms will be determined primarily by the ability of the large banks to discover and exploit new profitable opportunities within domestic and across country boundaries. An analysis of the major structure and performance characteristics of top banks operating in the EC (between 1985 and 1987) has been undertaken by Molyneux (1988). The most important findings are as follows:

- Top French banks are on average the largest in the EC, but employ considerably less staff than their UK counterparts.
- The major UK banks have the largest branch networks and employ considerably more staff than their counterparts in other EC countries.
- The labor-intensive nature of the UK payments system and the different production functions of UK banks compared with EC banks are usually cited as important causal factors in this differentiation.

### 3.1.4 Regulation and Governments in Banking Industry

Many writers on multinational banks have stressed the influence of government in explaining where they invest and what business they undertake. Government intervention in banking has been particularly extensive. This is because banking is not merely one economic sector among many. Banks have an impact on all other sectors through their lending policies; on large numbers individuals through their deposit-taking function; and on the general financial and monetary condition of an economy. Problems of information asymmetry and moral hazard have led governments since the nineteenth century to establish non-commercial central banks (*Banks as multinationals*, edited by Geoffrey Jones, 1990). Although there has been a criticism of state intervention in banking, as

Richard (1986) argued that restriction and control has been the fate of the banking industry in every developed economy.

In the nineteenth century, governments regulated or promoted multinational banking activity by their nationals. British overseas banks operated under Royal charters issued by the British Treasury, which obliged these banks to meet certain conditions. In the United States, Federal law forbade national banks to branch abroad until 1913. The Japanese government promoted the Yokohama Specie Bank in 1880, and sustained the bank by allowing it privileged rediscounting facilities and by not allowing domestic Japanese institutions to compete for its business until the First World War, by which time it was well-established. Home governments have continued to influence their multinational banks in the twentieth century. The formidable surge in Japanese multinational banking in the 1980s was partly the consequence of domestic regulatory environment and interest rate control within Japan, which led to London branches being extensively used as a flexible funding source to support lending inside Japan, while American branches were used in part to extend loans to Japanese-based companies (Geoffrey, 1990).

Governments also exercised a strong influence on the direction of multinational banking investment through host-economy regulations. In the United States, regulations and restrictions from the early nineteenth century greatly curtailed the ability of foreign banks to make direct investments. In Africa, Latin America and Asia, the growth of host-government regulation on foreign banks was one element in the declining competitive advantages of the British overseas banks. More recently, the lead-up to the Single European Market in 1992 has encouraged cross-border acquisitions and alliances within the European Community as banks seek to take advantage of the new institutional context (Geoffrey, 1990).

Just as governments have sought to restrict and prohibit, banks have sought to evade or take advantage of such restrictions, and this too has stimulated multinational banking. The growth of the Eurodollar market in effect owed its birth in the late 1950s to American restrictions on interest paid on

deposits within the United States, combined with British government restrictions on sterling lending by its banks. The Eurodollar market provided a major incentive for American banks to establish a branch in London, and later in various offshore centers (Geoffrey, 1990).

In short, governments have in the past -and are as likely to in the future- regulated and controlled banking. Much of government intervention stemmed from motives that were not economically 'rational', including ideologies based on past historical experiences and concerns about national sovereignty. As a result, the process of selection of the most efficient organizational form for banking activities came less through competition and rational evaluation of alternatives than through the actions of politicians and regulators (Geoffrey, 1990).

In September 1999 Finance Ministers and central bank Governors of the Group of Ten, plus Australia and Spain, asked their Deputies to conduct a study of financial consolidation and its potential effects. The definition of the financial sector in their study includes commercial banking, investment banking, insurance and asset management. The report encompasses broad issues associated with consolidations in financial sector in the 1990s, including pattern of consolidation, the causes of consolidation, effects of consolidation, the impact of financial sector consolidation on monetary policy, the effects of consolidation on efficiency, competition and credit flows, and the effects of consolidation on payment and settlement systems.

With regards to our study, we do not intend to review all these aspects here. Due to limited access to firms' information in our study, we just focus on the most relevant issues, which are causes of consolidation and effects of consolidation. We are going to look through causes, as many as possible, but only to study effects of consolidation on efficiency, despite other effects, such as on competition and credit flows, and on payment and settlement systems also mentioned in The G10 report. Readers can go to [www.bis.org](http://www.bis.org) to see more details for other effects. The reason we need to discuss effects of consolidation on efficiency is that cost savings and revenue enhancements are the primary motives for financial consolidations. We like

to see, both in G10 countries and later in countries or economies in our study, that how the efficiency of firms was affected when and after consolidation takes place if this is the main cause for consolidation.

## **3.2 Fundamental Causes of Consolidation on Financial Sector**

The primary motives for financial consolidation, as the report found, are cost savings and revenue enhancements. The most important forces encouraging consolidation are improvements in information technology, financial deregulation, globalization of financial and real markets, and increased shareholder pressure for financial performance. With respect to globalization, the Euro has accelerated the speed of the financial market integration in Europe and encourages cross-border activity, partly through consolidation (The G10 Report, 2001).

Diverse domestic regulatory regimes and corporate and national cultural differences are important factors discouraging consolidation. The future trend, according to the report, is characterized by a continuation of the current trend towards globally active and universal financial service providers, the emergence of more functionally specialized financial firms within a given segment of the financial industry and continued consolidation but a more radical form of specialization through the gradual “deconstruction” of the supply chain via the outsourcing of certain activities (e.g. internet services) to both financial and non-financial third parties.

### **3.2.1 Theory Framework**

In The G10 Report, the analysis distinguishes between motives for consolidation and the environmental factors that influence the form and pace of consolidation. The environmental factors are divided into two categories: those that encourage consolidation and those that discourage consolidation.

The motives for mergers and acquisitions are broken down into two basic categories. Value-maximizing and non-value-maximizing motives. In a world characterized by perfect capital markets, all activities of financial institutions would be motivated by a desire to maximize shareholder value. In the “real” world, while value maximization is an important factor underlying most decision, other considerations can, and often, do, come into play. (The G10 Report, 2001).

***Value-maximizing motives.*** The value of financial institutions, like any other firms, is determined by the present discounted value of expected future profits. Mergers can increase expected future profits either by reducing expected costs or by increasing expected revenues. Mergers can lead to reductions in costs for several reasons, including:

- Economies of scale (reductions in per-unit cost due to increase scale of operation);
- Economies of scope (reductions in per-unit cost due to synergies involved in producing multiple products within the same firm);
- Replacement of inefficient managers with more efficient managers or management techniques;
- Reduction of risk due to geographic or product diversification;
- Reduction of tax obligations;
- Increased monopoly power allowing firms to purchase inputs at lower prices;
- Allowing a firm to become large enough to gain access to capital markets or to receive a credit rating;
- Providing a way for financial firms to enter new geographic or product markets at a lower cost than that associated with de novo entry.

Mergers can lead to increased revenues for a variety of reasons, including:

- Increased size allowing firms to better serve large customers;
- Increased product diversification allowing firms to offer customers “one-stop shopping” for a variety of different products;

- Increased product or geographic diversification expanding the pool of potential customers;
- Increased size or market share making it easier to attract customers (visibility or reputation effects);
- Increased monopoly power allowing firms to raise prices;
- Increased size allowing firms to increase the riskiness of their portfolios.

***Non-value-maximizing motives.*** Managers' actions and decisions are not always consistent with the maximization of firm value. In particular, when the identities of owners and managers differ and capital markets are less than perfect, managers may take actions that further their own personal goals and are not in the interests of the firm's owners. For example, managers may derive satisfaction from controlling a larger organization or from increasing their own job security. Thus, they might engage in mergers designed to increase the size of the firm or reduce firm risk, even if such mergers do not enhance firm value. Managers may acquire other firms in order to avoid being acquired themselves (defensive acquisitions), even if being acquired would benefit the firm's owners. In some cases, managers may care about the size of their firm relative to competitors, leading them to engage in consolidation simply because other firms in the industry are doing so (The G10 Report, 2001).

### 3.2.2 Empirical Evidence on the Motives for Consolidation

Numerous empirical studies have attempted to determine the motives for mergers, both within the financial services and more broadly. Unfortunately, the actual motives for mergers are not directly observable and may differ from those stated by management at the time of merger announcement (The G10 Report, 2001).

***Economies of scale and economies of scope.*** Many researchers have estimated the relationship between average cost and firm size or product scope for the banking industry, in an attempt to determine the importance of economies of scale and economies of scope in banking. Overall, these

studies seem to support the view that economies of scale may be a motivating factor for mergers involving small or medium-sized financial services firms, particularly during the 1990s. They do not provide support for the view that economies of scale are an important factor driving mergers involving the very largest firms in the industry (The G10 Report, 2001).

***Cost efficiency.*** In some cases, managers do not operate a firm in a manner that minimizes the cost of producing given quantities and combinations of products. In this case, the firm is said to suffer from cost inefficiency. Consolidation can help to eliminate cost inefficiency if the acquiring firm's management is more effective at minimizing costs than the target's management, and is able to eliminate unnecessary cost after the combination takes place. Studies of the characteristics of the firms involved in financial sector mergers and acquisitions generally support the view that efficiency gains motivate consolidation. However, studies that examine ex post changes in cost efficiency resulting from mergers and acquisitions generally fail to find any evidence that efficiency gains are realized. The consistent failure of research to document efficiency gains from mergers may reflect accounting complexities that make it very difficult to measure changes in cost efficiency or unanticipated difficulties in achieving post-merger efficiency gains.

***Monopoly power.*** Although studies on this aspect are very few, some studies found that mergers are likely to increase market power in terms of significant price effect, particularly when the merging firms are direct competitors and their combinations result in a substantial increase in market concentration.

***Non-value-maximizing motives.*** When capital markets are imperfect and there is separation of ownership from management, managers may undertake consolidation that is not in the interests the acquiring firm's owners. A number of mechanisms exist to reduce the probability of managers engaging in activities that are contrary to the interests of the firm's owners. These include:

- Managerial stock ownership. If managers own a substantial amount of stock in the firms they run, they are likely to have a personal interest in maximizing firm value.
- Concentrated shareholder ownership. If shareholder ownership is highly concentrated, shareholders are likely to do a better job of monitoring managerial behavior than if shareholder ownership is widely dispersed.
- Presence of independent outsiders on the board of directors. Likewise, monitoring of managerial behavior is likely to be easier or more effective if there are independent outsiders on the firm's board of directors.

Numerous studies of non-financial firms and a few studies of commercial banks have examined the extent to which these mechanisms reduce the probability of managers entering into non-value-maximizing mergers. Although the studies do find evidence that these mechanisms are somewhat effective, their findings provide support for the view that at least some mergers are undertaken for reasons other than value maximization.

The G10 Report also disclosed the result of its interview concerning motives of consolidation among these countries:

***Within country, within-segment mergers.*** The single strongest motivating factor appears to be the desire to achieve economies of scale. More than 80% of respondents indicated that economies of scale were “very important” in motivating this type of consolidating. This finding contrasts sharply with the findings of the academic literature. Other important motivating factors for within country, within-segment mergers, were revenue enhancement due to increased size and increased market power. It was also mentioned that larger banks are better positioned to support large bond issues because they have access to a larger capital base, command a more extensive network to place these issues in the market, and have the advantage of name recognition. Risk reduction due to product diversification and change in organizational focus were considered largely irrelevant for this type of consolidation while economies of scope, revenue enhancement due to product diversification, and managerial empire building and entrenchment were considered to be slightly important.

***Within country, across-segment mergers.*** The most important motive appears to be revenue enhancement due to product diversification, or the ability to offer customers “one-stop shopping”. The desire to achieve economies of scope was perceived by interviewees to be the second most important motive for this type of merger. Economies of scale, revenue enhancement due to increased size, risk reduction due to product diversification, change in organization focus, market power, and managerial empire building and entrenchment were all considered to be slightly important factors.

***Within-segment, across-border mergers.*** Many respondents suggest that the strongest motives for such consolidations were increased market power and revenue enhancement due to both increased size and increased product diversification.

***Cross-segment, cross-border mergers.*** Revenue enhancement was also considered to be a strong motivator, but increased market power was viewed as only slightly important.

### 3.2.3 Forces Encouraging Consolidation

This section is concerned with the external forces that have encouraged consolidation in the financial sectors. Among the major forces creating changes are:

- Technological advances
- Deregulation
- Globalization of the marketplace
- Shareholder pressure
- The introduction of the Euro

***Technological advances*** Technology has both direct and indirect effects on the restructuring of financial services. Direct effects of technology may include:

- Increasing in the feasible scale of production of certain products and services (e.g. credit cards and assets management)
- Scale advantages in the production of risk management instruments such as derivative contracts and other off-balance sheet guarantees; and
- Economies of scale in the provision of services such as custody, cash management, back office operations and research.

Many wholesale services, in particular, have high technology investment costs but low margins, given customers' demands for increasingly sophisticated services at lower prices. Providers of these services often pursue mergers and acquisitions as a means of spreading the high set-up costs of new technological infrastructure over a larger customer base. The same may be true of providers of retail products like credit cards. A large firm size helps to counterbalance competitive pressures and provides the wherewithal for the continuous technology upgrades necessary to achieve any unit-cost advantage in pricing services that are basically commodity products. Large size may also provide diversification benefits.

***Deregulation.*** Governments influence the restructuring process in a number of ways:

Through effects on market competition and entry conditions, such as placing limits on or prohibiting cross-border mergers or mergers between banks and other types of services providers;

- Through approval or disapproval decisions for individual merger transactions;
- Through limits on the range of permissible activities for service providers;
- Through public ownership of institutions; and
- Through efforts to minimize the social costs of failure.

Over the past two decades, many official barriers to consolidation have been relaxed as governments have reconsidered the legal and regulatory

framework in which financial institutions operate. In a number of countries, regulations in the financial services industry, especially as applied to banking organizations, tended in the past to focus almost on safety. However, financial regulatory frameworks in most major countries have shifted from systems based on strict regulatory control to systems based more on enhancing efficiency through competition, with an emphasis on market discipline, supervision and risk-based capital guidelines. In the new operating environment, public policy is less protective of financial service providers, exposing them to the same sorts of market pressures that have long confronted non-financial businesses.

***Globalization.*** Globalization is in many respects a by-product of technology and deregulation. Technological advances have lowered computing costs and telecommunications, while at the same greatly expanding capacity, making a global reach economically more feasible. Deregulation, meanwhile, has opened up many new markets, both in developed and in transition economies. As a factor encouraging consolidation, globalization largely affects institutions providing wholesale services. As indicated by interviewees in The G10 report, global corporations expect financial service providers to have the necessary expertise and product mix to meet any investment or risk management need in any location in which the corporations have operations. As non-financial corporations increased the geographic scope of their operations, they created a demand for intermediaries to provide products and services attuned to the international nature of their operations. Maintaining a presence in multiple financial markets and offering a breadth of products and services can entail relatively high fixed costs, creating a need for a larger size to achieve scale economies.

Meanwhile, profit margins in many wholesale business segments have narrowed as a result of increased ease of entry and the commodity-like nature of many wholesale financial products. Low margins, in effect, mean that high volume is necessary to generate higher returns. This need has prompted some firms to opt for mergers and acquisitions as a means of attaining critical mass. Mergers and acquisitions have also been a frequent

option for banks seeking to build a global retail system. By acquiring an existing institution in the target market, the acquirer gains a more rapid foothold than would be possible with an organic growth strategy. Acquisitions of large shareholding in the Latin American financial sector by Spanish institutions are an interesting example of cross-border consolidation. The main countries that have been involved in the region are Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. A number of factors have supported these efforts. Most governments in the targeted countries have taken steps to modernize their economies and, in particular, reform their banking and financial systems through deregulation, restructuring and privatization, while opening their domestic markets to foreign institutions. Other supporting factors include:

- The importance of the common language, historical ties and other cultural factors;
- The strong financial solvency position of the acquiring banks, coupled with the need to implement strategies that increase shareholder value;
- Higher potential growth in these countries compared with the EU.
- Higher intermediation margins in Latin American banking systems compared with those of more developed countries;
- The adaptability of readily available products and delivery systems;
- Minimal correlation between the economic cycles of Latin America and Spain, which allows some risk diversification.

In addition to increasing the need for wholesale service providers to expand the scale of their operations, globalization has helped change the competitive dynamics of other market segments. Many financial products are now offered internationally by efficient global competitors, through direct or targeted distribution channels. Some traditional retail banking products and services are still provided on a regional or local level, but a few global providers have begun to make competitive inroads in many markets. National and regional players are forced to respond to the threat posed by new entrants either by emulating their product offerings, which results in commoditisation, or by offering better pricing, which requires increased

efficiency, or by offering better services, such as through customization or personal service.

The globalization of capital markets also contributes to the shift from a bank-centered system to a market-based one. As capital markets have expanded and become more liquid and efficient, the highest-quality credits have turned increasingly to the commercial paper and bond markets in lieu of certain types of traditional bank and insurance products. Margins on loans to the highest-rated investment grade borrowers have been driven down to the point where only the most efficient institutions are able to provide this form of credit. On the liabilities side of banks' balance sheets, there has been a substantial outflow of deposits to a wide range of competing financial products offered by various institutions in different sectors.

A final influence of globalization is in the area of corporate governance. As business have crossed international boundaries and their shares have begun to be held by a wider investor clientele, the demand by investors for a more uniform standard of corporate governance has also increased. Generally, the pressure for change has come from shareholders located outside the home market. A major contributing factor is the ongoing change in investor demographics.

***Shareholder pressures.*** The shareholder value concept has become more widespread and more important with a focus on the return on assets and the return on equity (ROE) as benchmarks for performance. This emphasis on ROE is most evident in countries where capital markets exert strong competitive pressures, but its importance is spreading rapidly. Managers have sought ways to increase revenues, create new sources of earnings, generate fee income, reduce cost-to-income ratios, optimally deploy excess capital or, for some institutions, recapitalize after a major crisis. These goals can be achieved through business gains, productivity enhancement or more effective balance sheet management, but mergers and acquisitions appear to be a simple strategy for many institutions (The G10 Report, January 2001).

***The introduction of the Euro.*** Another development that has had an impact on the competitive environment for some institutions is the creation of the euro. The general view of the Euro is that it acts as a catalyst, reinforcing already existing trends in the EU banking systems. Since its inception, the Euro has quickly led to an integrated money market, thereby affecting the motives for consolidation.

### 3.2.4 Forces Discouraging Consolidation

Those factors that discourage consolidation include regulatory regimes, information failures, cultural differences, structures in corporate governance and various other factors.

***Regulation.*** The legal and regulatory environment represents a substantial potential impediment for consolidation, as it directly affects the range of permissible activities undertaken by financial firms and may imply considerable compliance costs. Potential regulatory impediments to consolidation include:

- Protection of “national champions”. In some countries, the government has an explicit role in approving foreign investment in domestic financial institutions. Governments may protect domestic enterprises by setting high hurdles for foreign buyers attempting to acquire majority stakes. Conditions in some countries have enabled some categories of banks to remain insulated from market forces.
- Government ownership of financial institutions. The scope for consolidation is similarly limited when banks are partially or fully government owned. For these institutions, the consolidation of business activities with other would have to be preceded by privatization.
- Competition policies. Competition policies are concerned with the negative welfare effects stemming from a lack of competition. Some consolidation projects are refused on the grounds that they would result in market dominance. A further important deterrent related to competition policy rules is the fact that some mergers have to pass the test of

competition authorities in different countries, which involves long delays, compliance costs and uncertainty

- Rules on confidentiality. National regulations with regard to data provision and confidentiality may prevent the consolidation of information platform on a cross-border and an across-segment basis and, thereby, impede potential cost reductions from technologically induced economies of scale.

***Cultural differences.*** Cultural difference appears in the consolidation process on the corporate level, between sectors, across regions or countries and between wholesale and retail businesses. The need for cultural integration as part of the consolidation process is a multidimensional issue that touches all stakeholders. Cultural differences increase the complexity, and therefore the costs, of managing size. Post-merger problems have often been ascribed to the underestimation of the difficulties involved in attempts to combine different cultures.

- Differences between countries. The importance of cultural differences is especially obvious when a merger crosses national borders or spans geographically distinct regions. Factors that may discourage consolidation include differences in language, communication styles, customer needs and specific established distribution channels. These factors determine the ease, and thus the implicit costs, of a firm's entry into a different country or region.
- Differences in corporate cultures. Strong corporate identities are considered to be particularly problematic in mergers between equals. Takeover attempts often turn unfriendly when there are large perceived rifts in business cultures between the acquirer and the target. Such differences may impede the exchange of information, the pursuit of common objectives and the development of a coherent corporate identity. Divergent corporate cultures may exist between corporations within the same business segment, as well as across business lines.

***Inadequate information flows.*** Inadequate information flows are related with market inefficiency that may increase the uncertainty about the

outcome of a merger or acquisition. They may be attributed to incomplete disclosure or large differences in accounting standards across countries and sectors. When faced with such an information asymmetry, stakeholders may disapprove of consolidation.

- Lack of comparability of accounting reports. Large variations in accounting principles and procedures from country to country or even across sectors can impede consolidation, as there may be considerable uncertainty regarding the risk profile and evaluation of the assets of the institutions involved in the transactions. The growing complexity of large transactions in recent years has further increased the importance of reliable and transparent accounting standards in order to conduct adequate due diligence procedure in mergers and acquisitions.
- Difficulties in asset appraisal. The existence of asymmetries is a commonly acknowledged complication in appraising assets particularly in the context of bank's loan books, which include assets for which market liquidity is low. An assessment of the loan book of an institution implies the difficult task of judging the quality of risk management of the takeover target, which is especially problematic in the context of evaluating single loans.
- Lack of transparency. Ex ante pressure from shareholders to justify a merger decision may be a discouraging factor in the presence of uncertainty and information asymmetries. The potential for hidden costs, as a result of a lack of transparency, may induce acquiring management and shareholders to be more risk averse when considering an acquisition.

***Corporate governance.*** Corporate governance encompasses the organizational structure and the systems of checks and balances of an institution. There are significant difference in the legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management, which affected the interrelation of the two decision-making bodies within an institution and relations with the firm's owners and other stakeholders, including employees, customers, the community, rating agencies and government.

- Ownership structures. The organizational form and rules that govern the strategic business decisions of a company have a large bearing on whether consolidation is deemed a valid business option.
- Capital structure. Corporate governance should not be viewed independently from corporate finance. As the way of raising capital varies, so do the possibilities for influencing or pressuring the supervisory board with regard to decisions on consolidation. Such influence appears to be greatest for firms that rely heavily on equity financing and whose shares are widely held. Where there are a few large shareholders, it is extremely difficult to sway the vote of the governing board without their express approval.
- Existence of defensive strategies. Defenses against a takeover are strongest where financing is from private sources and the major share of equities is privately held. Defensive strategies are manifold and include payoff provisions from managers, i.e. “golden parachutes”, or legal and technical obstacles such as complex ownership agreements or cross-shareholding with other institutions.

### **3.3 Consolidation and Efficiency**

#### 3.3.1 The Measurement of Efficiency

According to a narrow technical definition, a firm is cost-efficient if it minimizes cost for a given quantity of output: it is profit-efficient if it maximizes profits for a given combination of inputs and outputs. The narrow definition takes size and technology as given, and focuses on measuring managerial efficiency (the optimization of existing resources) by analyzing how production factors are combined (The G10 Report, January 2001).

A more comprehensive definition considers scale and scope economies: an efficient firm is one that reaches the optimal size for its industry (size) and that produces the optimal mix of products given the prices of their production factors (scope). The minimum efficient size and optimal product mix vary with technologies, regulations and consumers' tastes. Therefore, there should be wide variations in firm structure across time, industries and

countries if firms fully exploit scale and scope economies (The G10 Report, January 2001).

According to The G10 Report, there are several measurement methodologies, based on the two definitions. The simple approach consists of comparing balance sheet ratios that describe cost (e.g. operating costs over gross income) and profitability (e.g. return on assets or on equity). However, this methodology is thought to be not fully taking into account the complexity of the financial industry. More complex analysis measure managerial cost and profit efficiency by comparing firms to the best practice of the industry. A frontier along which all efficient firms would operate is estimated, and then the distance of each actual firm from the frontier is taken as a measure of its (in) efficiency.

Finally, for firms listed on a stock exchange, efficiency gains can be measured on the basis of stock market performance: a firm is thought to be doing well when its shares outperform a given benchmark (the industry average or an index of firms of comparable size). The overall efficiency gains from a merger are evaluated in terms of the sum of the market values of the bidder and the target: if the sum increases, the deal is supposed to create value, and vice versa if it decreases (The G10 Report, January 2001).

The Report suggests that differences in regulations, institutions and market structure across countries mean that conclusions drawn from the analysis of one country should be generalized to others only if very carefully done.

### 3.3.2 Empirical Evidence

Some evidence concerning cost and profit efficiency, which can be found in The G10 Report:

- Only relatively small banks could generally become more efficient from an increase in size. However, changes in technology and market structure might affect scale and scope economies in the future. In addition, the direct evidence on how M&As affect banks' performance is mixed. In

general, more efficient banks acquire relatively inefficient banks, but there is little evidence of subsequent cost reduction. For deals consummated over the last decade, there is some evidence of improvement, especially on the revenue side. The gains, however, are probably not as large as those anticipated by practitioners (The G10 Report, January 2001).

In the United States, there is little evidence of any improvement in cost efficiency following a merger. As for profit efficiency, research performed on US banks finds an improvement, due mainly to an increased diversification of risks (Akhavain, Berger and Humphrey, 1997; Berger, Hancock and Humphrey, 1993; Berger, Humphrey and Ulley, 1996; Berger and Mester, 1997; and Clark and Siems, 1997). The reduction in risk allows them to lend more per unit of equity, thus earning higher returns (The G10 Report, 2001).

In Europe, the evidence of cost efficiency exists: one study finds that domestic mergers among banks of equal size improve cost efficiency, but this result does not hold for all countries; cross-border acquisitions are associated with a reduction in the costs of the target, while no effect is found for domestic M&As (Altunbas, Molynux and Thornton, 1997; Focarelli, Panetta and Salleo, 1999; and Vander Vennet, 1996). As for profitability, more efficient banks tend to acquire institutions in worse shape. Mergers have a positive impact on profitability, mainly driven by improvements in operational efficiency; however, deals that consist of the purchase of the majority of the voting shares of the target do not appear to result in significant improvements (Vennet, 1996). One study finds that Italian banks merge in order to change their business focus towards providing financial services and thus increase their non-interest income, rather than to obtain efficiency gains (Focarelli, Panetta and Salleo, 1999); the increase of profitability that is observed after M&As is related also to a more efficient use of capital (Focarelli, Panetta and Salleo, 1999).

- The main finding of studies that examine share prices around the time that a merger is announced is that, on average, total shareholder value is not affected by the announcement of the deal. On average, the bidder

suffers a loss that offsets the gains of the target. Put differently, M&As seem typically to transfer wealth from the shareholders of the bidder to those of the target (The G10 Report, 2001).

For US banks, one study finds that the combined gains to be higher when there is significant overlap between institutions, consistent with a market power hypothesis, which says that higher market share leads to higher profits. Another paper finds, consistent with a diversification hypothesis according to which geographical diversification leads to a lower variability of incomes, that it is out-of-market transactions that create value for shareholders (Houston and Ryngaert, 1994 for the market power hypothesis and Zhang, 1995, for the diversification Hypothesis). In both cases, the market value of the two banks combined should be higher than the sum of their values as separate entities (The G10 Report, 2001).

Higher market concentration created by consolidation is likely to lead to an increase in prices for retail financial services, leading in turn to an increase in profits. However, it is also true that firms operating in more concentrated markets are generally found to be less efficient: this might offset the gains from an increase in market power and thus leave unchanged the market value of the bank (The G10 Report, 2001).

### **3.4 Different Perspective**

Consolidation in financial sectors could also be thought of as the integration of financial market among countries, which is the process of globalization. Claessens and Glaessner's report of *Internationalization of Financial Services in Asia* discusses the links between three important reforms: internationalization of financial services, domestic financial deregulation, and capital account liberalization. Their empirical study covers eight Asian countries or economies, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand and India, and suggests that the limited openness to foreign financial firms has been costly in terms of slower institutional development, greater fragility and higher costs of financial services. The report reviews the development of banking services, securities

markets and life-insurance in these eight Asian economies. For banking services, there is a positive relationship between profitability and openness, demonstrating that openness encourages banks to reduce costs and diversify their income (by greater reliance on fee-income). The more closed Asian banking system also appears less institutional developed and more fragile. For securities markets, there is a positive relationship between the degree of openness and measures of functional efficiency. For life-insurance markets, negative relationships exist between pay-back and operating costs and openness. Finally, the cross-country empirical evidence finds that Hong Kong is the best as both open as well as efficient and robust financial markets for all three types of financial services in the eight economies.

#### 3.4.1 The Internationalization of Financial Services

The internationalization of financial services is defined, according to that report, as eliminating discrimination in treatment between foreign and domestic deregulation financial services providers and removing barriers to the cross-border provision of financial services.

Internationalization relates to the degree of capital account liberalization as it determines the potential gains and benefits from access to foreign financial services provided domestically relative to access provided and obtained offshore. Internationalization also relates to domestic financial deregulation as the degree of regulation influences the quality and competitiveness of domestic financial services providers (Claessens and Glaessner, 1998). Domestic financial deregulation is intended to allow market forces to work by eliminating controls on lending and deposit rates and on credit allocation, by reducing demarcation lines between different types of financial service firms, and more generally by reducing the role of the state in the domestic financial system. Capital account liberalization involves a process of removal of capital controls and restrictions on the convertibility of the currency.

### 3.4.2 Internationalization and Domestic Financial Deregulation

Claessens and Glaessner (1998) argues that internationalization and domestic are related, but not in any easy or straightforward way. On the one hand, a country might deregulate its financial system but still keep its financial markets closed to foreign competition, as the example of Japan, who has been deregulating its domestic financial system, but is still often singled out by other developed countries as being relatively closed to foreign financial service providers. On the other hand, a country might over-regulate its domestic markets for financial services, but freely allow foreign financial firms to enter the local market. Banking in the US, for example, is often criticized as over-regulated, yet US financial-service markets are very open to foreign FSPs.

The costs and benefits of internationalization of financial services will to a significant degree depend on the efficiency and competitiveness of the domestic financial system, which in turn will importantly be influenced by the nature of domestic regulation (Claessens and Glaessner, 1998). Claessens and Glaessner (1998), also argue that countries with a highly regulated domestic financial system may well suffer from inefficiencies and poor quality and breadth of financial services. Opening up to FSPs may in the short run negatively affect domestic FSPs, but in the long run they will benefit from opening up.

### 3.4.3 Internationalization and Capital Liberalization

Research has generally found that reducing controls on international capital movements can lead to lower costs of capital and greater risk diversification. The quality of the financial system, however, is a central factor. Countries with weak financial systems, particularly in terms of supervision, have sometimes experienced financial distress following a period of rapid inflow of foreign capital associated with the earlier removal of controls on international capital movements (Honohan, 1997a, Goldstein and Turner, 1996, Mathieson and Roja-Suarez, 1993, World Bank, 1997a).

The authors state that internationalization and capital account liberalization are related, but not in an obvious way. With an open capital account, equities issued in developing-country markets, might be largely traded in New York in the form of an American Depository Receipt -but perhaps still owned by co- nationals of the original issuer. Or domestic firms may avail themselves of off-shore financial services: many Asian firms, for example, borrow abroad and then repatriate funds in domestic currency for local use. Such cases involve both the movement of capital across borders and the use of foreign financial services, without the entry of foreign financial firms.

The degree of capital account liberalization can affect the costs and benefits of internationalization. First, capital account liberalization affects the incentives of foreign FSPs to establish presence in the country. Second, it determines the extent to which classes of domestic firms and individuals can avail themselves of foreign financial services. Third, it can imply varying costs across different users of financial services in the event of financial crisis. Fourth, segmentation can affect the political economy of internationalization.

#### 3.4.4 Conceptual Framework

The starting point for the study of internationalization of financial services is whether the theory of comparative advantage and the empirical evidence on the benefits of openness developed for trade in goods applies to trade in services. The general conclusion of research on this topic is that the broad conclusions of comparative-advantage theory hold also for services -and thus that internationalization of services has large potential benefits for developing countries as they are comparatively less well-endowed but require modification in the detail of the analysis to take account of the differences between goods and services. Internationalization of financial services, however, is a much more recent field of study and has been studied much less systematically (Claessens and Glaessner, 1998).

According to Claessens and Glaessner's report, international transactions in goods and international transactions in services, especially in financial

services, differ in two important ways. First, provision of services often requires the provider of the services to have a local presence. It is very difficult to obtain information for the efficient provision of financial products from a foreign location, since detailed information is often tailored to client characteristics. And because of the service's intangible nature, regulators may actually require domestic presence to ensure that they maintain control. Second, the provision of financial services is typically regulated, for both fiduciary and for monetary-policy purposes. The case for such regulation is universally accepted and is not at issue when it comes to the internationalization. Regulations, however, affect the cost of providing a service. Hence, when FSPs subject to one set of regulations compete with FSPs subject to another, one element in the outcome of the competition is the relative cost of complying with the different regulatory systems. Differences in regulations between countries may thus affect, fairly or unfairly, competition in trade of services across borders as well as the local provision of financial services by foreign firms (Claessens and Glaessner, 1998).

#### 3.4.5 Benefits

As the removal of barriers to trade in goods allows for specialization according to comparative advantage and can lead formerly-protected producers to improve their efficiency, so can foreign involvement in markets for financial services lead to an improvement in the overall functioning of domestic financial systems (Claessens and Glaessner, 1998). Levine (1996), who surveys these issues and the existing literature on internationalization, identifies three specific potential benefits: (a) better access to foreign capital; (b) better domestic financial services; and (3) better domestic financial infrastructure (including improved regulation and supervision), with the last two being the most important benefits of internationalization for developing countries.

The specific benefits that countries might expect in these last two areas include: a more efficient financial sector; a broader range and improved quality of consumer service; better human skills; pressures for improved

regulation and supervision, better disclosure rules and general improvements in the legal and regulatory framework for the provision of financial services; improved credibility of rules (as the country enters into international agreements and intensifies linkages with foreign regulators, thereby lowering the risk of policy reversals). These benefits of internationalization can follow both through top-down actions on the part of government and through bottom-up pressures from the markets as best international practices and experiences are introduced and competitive pressure increases (Claessens and Glaessner, 1998).

As in other sectors, openness to foreign competition allows consumers to obtain better and more appropriate services more cheaply and puts pressure on domestic financial firms to improve their productivity and services. It also allows financial firms' access to technologies and ideas to financial services, a desire expressed by some Asian countries. Internationalization will also put pressures on improved supervision by authorities of domestic financial institutions. The presence of foreign FSPs can further help improve the screening of projects and monitoring of firms, thus leading to a better financial system. The most important benefits of an open financial system will likely stem from the positive spill-over effects on savings and investments and on the allocation of productive resources, which would translate into positive effects on economic growth (Levine, 1997).

#### 3.4.6 Costs

The theoretical arguments on costs of internationalization lie in both economic and political economy ones. Economic arguments against rapid internationalization are based on adjustment costs. First, the ability of domestic institutions to monitor a more complex financial system may be limited (as a consequence of, for example, a poor legal framework, a lack of the skills needed for supervision, and poor market discipline). In the light of such problems, too rapid internationalization may lead to larger systemic risks as foreign FSPs cannot be supervised and monitored properly. Second, in cases where the financial system is currently undercapitalized, rapid entry could lead to financial distress among domestic FSPs as profits decline. In

particular, the presence in banking system of large non-performing loans may require policies to maintain higher profits for existing banks, and therefore call for restrictions on the entry of new banks, both domestic and foreign.

Political economy arguments say that international competition will eliminate local FSPs and thus leave the domestic financial systems at the mercy of foreigners. Furthermore, it is claimed, foreign banks will operate only in very profitable market segments; they will have no commitment to the local market, and may contribute to capital flight. International competition must therefore be regulated, impeded and limited. These arguments are mainly put forward by interested parties standing to lose from opening up.

The relationships between internationalization, domestic deregulation, and capital account liberalization are thus complex. At present, a tightly defined theoretical and conceptual structure for analyzing the impact of these related issues is still missing and empirical evidence is only starting to become available.

### **3.5 Our Own Thoughts**

These two reports being as our main theoretical framework have different views. The first report or The G10 Report is mainly characterized by the individual company's perspective. It distinguishes between motives and environmental factors for consolidation on financial sector. Furthermore, those motives are divided into value-maximizing motives and non-value-maximizing motives. The second report, *internationalization of financial services in Asia*, is starting from the financial services industry's perspective. It is dealing with the benefits and costs of the openness of domestic financial market to foreign financial firms, and discussing the relationships among deregulation, capital account liberalization and internationalization of financial services. Secondly, although the two reports seem to be more of a practical nature, their studies are definitely based on the theoretical thinking. The first report looks at shareholder value and impacts of external factors.

The conceptual framework for the second report is the application of the theory of comparative advantage in financial service. This difference could provide us the direction for our future study in this field.

These two perspectives actually also involve each other. Indeed, we would say that they are looking at the same thing but from different angles. From the individual company's point of view, globalization, deregulation and the development of the financial market are environmental factors or driving forces for spurring consolidation on financial sectors, whether within the country and same sector or across borders and different sectors. From the industry's point of view, one can see internationalization of financial services and the openness to foreign financial firms as the catalysts to further consolidation among the companies. Globalization and internationalization we feel are a little bit different from each other. The first report studies on G10's financial sectors, which are all developed countries in the world. Their financial service industry is much more developed and advanced. Globalization and liberalization of financial market have originated from those countries and spread all over the world. In light of this, we could see the clear relationship between globalization and internationalization of financial services in Asia, in our case.

Given the analysis above, we could name the first perspective as bottom-up approach while the second one as top-down approach. In other words, there are two ways available, at least in our study, to start our empirical study. We could analyze the individual company's M&A activity and then make generalization about the general trend. Or we can study from the industry's performance and then choose individual company to reflect the general development of the industry. We decided to choose the second approach, because:

First, the study of M&A on financial firms cannot be separated from the influence of the whole financial service industry. Sometimes, studies only focus on individual company would lead to a result, in contrast with reality, as we discussed in Chapter of Methodology.

Second, we are concerned about information disclosure. If taking the first approach for our study, probably we need a large number of companies as the sample, in order to generalize the industry trends. To a significant extent, this approach requires high-levelled accounting disclosure of the individual company. This might be one reason that I have seen many studies on financial service industry are concentrated on the US and EU, since their companies have traditionally had good transparency on information disclosure, compared with that of companies from Asia. However, from the industry' point of view, I feel transparency is not a problem as big as that in the company level, thanks to the existence of international organizations, such as BIS, the IMF and The World Bank Group.

In summary, by reviewing the relevant theories and taking into account our own study, we shall start our empirical study from looking at financial service industry. After that, we shall study the individual companies as a complement to our industry analysis.

## **4. Transformation of Economic Structure in Singapore and Hong Kong, and China's Economic Development**

### **4.1 The Economic Structure in Singapore and Hong Kong**

Before we proceed to banking industry, we need to describe the real economy development in Singapore, Hong Kong and China. The economic transformation, in Singapore and Hong Kong, from manufacturing oriented to service-industry oriented, especially promoting banking industry's development, has a close relationship with China's recent economic development, given the economic nature of Singapore and Hong Kong. We are going to make comparative studies on economy development between Singapore and Hong Kong and then we will give some descriptions of China's economic development.

#### 4.1.1 Singapore and Hong Kong's Economic Structure

Table 2 Structure of the economy of Singapore (% of GDP)

	<u>1980</u>	<u>1990</u>	<u>1999</u>	<u>2000</u>
Agriculture	1.6	0.4	0.2	0.1
Industry	37.7	34.4	34.6	34.3
Manufacturing	29.1	27.1	25.1	26.5
Services	60.8	65.3	65.2	65.6
Private consumption	52.2	46.2	38.4	39.8
General government consumption	9.8	10.2	9.8	10.5
Imported goods and services	223.6	194.9	-	-

Source: World Bank's Country survey.

[http://www.worldbank.org/data/countrydata/aag/sgp\\_aag.pdf](http://www.worldbank.org/data/countrydata/aag/sgp_aag.pdf)

Table 3 Structure of the economy of Hong Kong (% of GDP)

	<u>1980</u>	<u>1990</u>	<u>1999</u>	<u>2000</u>
Agriculture	0.8	0.3	-	-
Industry	31.7	25.3	-	-
Manufacturing	23.7	17.6	6*	-
Services	67.5	74.5	94*	-
Private consumption	59.7	56.7	59.6	58.3
General government consumption	6.1	7.4	9.9	9.6
Imported goods and services	90.8	125.8	128	145.2

Source: World Bank's Country survey.

[http://www.worldbank.org/data/countrydata/aag/hkg\\_aag.pdf](http://www.worldbank.org/data/countrydata/aag/hkg_aag.pdf)

94\* and 6\* are from IMF's Country Report No. 1/146 and Country Report No. 1/43

For the two economies, industry as a share of GDP has decreased while the growth of service increased accordingly. Particularly, in the case of Hong Kong, its manufacturing in the percentage of GDP has decreased sharply, only accounted for 6% of GDP in 1999 while the service sector rose to 94% in the same year, suggesting that Hong Kong is in rapid change in the economic structure, with service industry as its growing dominance. As people in Hong Kong say that we in Hong Kong don't make things, but we make things happen.

The major sectors in Hong Kong's service industry include the trade and travel related sector (wholesale trade, retail trade, import/export, restaurants and hotels), which accounted for 25.4% of GDP in 1996; and financing, insurance, real estate and business services, which contributed 25% of GDP in 1996, up from 20% in 1990. Manufacturing as a percentage of GDP has

declined steadily as companies shifted production facilities to lower cost locations in China and elsewhere. According to the report by IMF (Country Report No. 01/43, March 2, 2001), by the end of 1999, the share of trade and financial services stood at 48 percent of GDP. In 1999, trade in goods and services stood at 260 percent of GDP, and cross-border financial transactions at 220 percent of GDP. It is concluded that Hong Kong has been transformed largely into an intermediating economy - intermediating international trade and capital flows (The IMF, country report No. 01/43 March 2, 2001).

As contrast to Hong Kong, the Singaporean Government has maintained its manufacturing sector as one of the most important sectors in the country's economy. According to the World Bank, the electronics industry contributes 45 percent to the total manufacturing output and approximately 12 percent of Singapore's overall GDP. Singapore manufactures about half the world's supply of computer disk drives, and exports significant volumes of semiconductors and other computer peripherals. However, the downturn of global economy has heavily hit Singapore's manufacturing industry, especially its electronics industry. Singapore also faces tough competition from its neighbors, particularly from China, due to the shift of comparative advantage. In response to the challenges, Singapore has chosen both to upgrade its manufacturing sector along the value-added ladder to enhance its technology level and to promote further development of service industry, especially on strengthening its role as one of financial centers. Just from this background, we will see that both Hong Kong and Singapore have introduced several measures to develop their financial service industry, thus influencing their banks' development.

#### 4.1.2 The Role of Government in Hong Kong and Singapore

Among other things, different rates of transformation from manufacturing-oriented to service-oriented economy has reflected that government policy has played different role in the two economies.

Hong Kong pursues a free market philosophy, and there is a minimum government interference with corporate operations. It welcomes foreign investment, but offers no special incentives nor does it impose disincentives for foreign investors.

Hong Kong's well-established role of law is applied consistently and without discrimination. There is no distinction in law or practice between investments by foreign-controlled and those controlled by local interests. Hong Kong's extensive body of commercial and company law generally follow that of the United Kingdom, which implicitly and explicitly promotes competition in all forms of economic endeavor.

All of Hong Kong is a duty-free zone, as it is a free port, with no tariff barriers. There is no capital gains tax nor are there withholding taxes on dividends and royalties. Foreign-owned and domestically owned firms are taxed at the same rate, 16% per cent of profits.

There are no direct subsidiaries to domestic industries and no discrimination against foreign investors either at the time of initial investment or afterwards. Profits can be freely converted and remitted. No preferential or discriminatory export and import policies are imposed to affect foreign investors.

There are no disincentives or any limitations for foreign investors on the use or transfer foreign currency. Capital flow is complete free for any purpose. The Hong Kong dollar is a freely convertible currency that, since late 1983, has been linked to the U.S. dollar at an exchange rate of HK\$ 7.8= US\$ 1. Authorities are committed to exchange rate stability through maintenance of the linked rate.

With few exceptions, Hong Kong does not attempt to limit the activities of foreign investors either in specified projects or sectors. Foreign investment in Hong Kong flows freely into the industrial sector as well as into services, franchises, the entertainment industry, and the ownership of property, both residential and commercial.

Foreign firms and individuals are allowed freely to incorporate their operations in Hong Kong, to register branches of foreign operations, and to set up representative offices without any discrimination or undue regulation. There is no restriction on the ownership of such operations. Company directors are not required to be citizens of, or resident in Hong Kong.

In short, non-interventionist economic policies, complete freedom of capital movement and a well-understood regulatory and legal environment have greatly facilitated Hong Kong's growing role as a regional and international financial center. According to the Hong Kong government's survey, there were 2530 regional operations by overseas companies in 1997. The United States has the largest number of regional headquarters in Hong Kong, followed by Japan and China. Hong Kong's foreign exchange market is the fifth largest next to Singapore in the world. Hong Kong has the highest number of authorized insurance companies in Asia. Its equity market is ranked second in Asia after Tokyo and seventh in the world in terms of capitalization.

Generally speaking, among other differences, the authorities in Singapore have played a very active role in the development of the economy by encouraging or discouraging foreign direct investment into specific sectors.

For manufacturing industry, the government established The Economic Development Board (EDB), the government's manufacturing investment promotion agency, screen investment proposals to determine their eligibility for various incentive schemes and provide assistance. While those investments that do not meet the criteria are not given incentives, they are not prohibited from proceeding. Rather the EDB has helped foreign investors avoid that area. We can just cite some of these incentives here: Approved Oil Trader (AOT) for promoting expanding international oil trade activities in Singapore; Approved International Shipping Enterprise (AIS) Incentive for international shipping companies; Approved Aircraft Incentive for international aircraft operation.

For financial service industry, through the Monetary Authority of Singapore (MAS), the Singapore government provides generous tax incentives to encourage leading foreign financial institutions to invest in the country, introduce new financial products and help the city-state achieve its aim of strengthening the position of the international financial center.

#### 4.1.3 Hong Kong's Integration with China

Hong Kong has continued to enjoy substantial economic autonomy following its return to Chinese sovereignty on July 1, 1997. China's Basic Law for Hong Kong, amplifying the meaning of "one country, two systems", includes separate monetary systems, separate financial and regulatory systems, separate budgetary regimes. With China's rapid economic development, especially its strong growing export sectors, Hong Kong has moved its manufacturing facilities to China in order to take advantage of low costs. The economic interdependence between Hong Kong and China has grown to the extent that they have become each other's largest trading partner and investor. According to HSBC's regional report on Hong Kong, trade between Hong Kong and China has grown strongly since 1978, at an average annual rate of 26%. Over the last decade, more than half the foreign investment in China came from or via Hong Kong. United Nations has recently published World Investment Report 2001, saying that in 2000 the 10 largest FDI recipients, as well as the 10 largest sources of FDI, were developed countries, with one or two exceptions from the developing world (China and Hong Kong). FDI to and from Hong Kong hit record levels last year primarily concentrated in Hong Kong, which overtook China as the single largest home and host economy in Asia, with \$64 billion inflows and \$63 billion outflow. One of the reasons offered by the report is that multinational companies planning to invest in Mainland China have been "parking" funds in Hong Kong, in anticipation of China's expected entry into the WTO.

In addition, Hong Kong is an important service center for China, providing financial and business expertise and services, market outlets as well as port, airport and other infrastructure facilities. In Hong Kong's equity market, a

total of US \$26.4 billion has been raised since 1993 by mainland-based or mainland-controlled enterprises. In 1997, 46 percent of new equity issued through the Stock Exchange of Hong Kong was such companies. Taking debt and equity together, over 60 percent of total capital raised by Mainland China internationally in 1997 came through Hong Kong. "Thus Hong Kong assists the Mainland to access international markets, without needing to open its domestic market at this stage of its development. At the same time, growing participation by Mainland issuers and intermediaries in the Hong Kong market is contributing to the spread of the financial market experience and skills on the Mainland. This symbiotic relationship between Hong Kong and Mainland China is a unique phenomenon in financial market history." (Douglas and Monika, 1999).

Many economists believe that over the coming years, the economic relationship between Hong Kong and China is likely to change as the latter enters the WTO. One view is concerned with Hong Kong's financial service sector, as China opens up its markets to foreign financial firms, Hong Kong's role in intermediating financial transactions in China will likely decline. Opponents to this view suggest that except the shift of some low value-added financial services to China, it is unlikely to decline so as long as China maintains capital controls and its financial markets remain relatively less developed. Indeed, Hong Kong will likely gain from the new opportunities in financial and management services that will arise from economic reforms in China.

## **4.2 China's Economic Development**

The study on Chinese economy requires a huge amount of work. What I am supposed to do here is to picture two aspects, which are related to our paper. One is that China's sustained and rapid development has challenged and pressed Asian countries to transform their economies. With the accession to the WTO, China's comparative and competitive advantage over Asian countries will become more apparent. The other is that China's development also creates opportunities for its neighbors. Specific to China's banking industry, some big players in the region, especially from Hong

Kong and Singapore, will find huge opportunities, as regards the vast market and poor performance of Chinese state-owned banks.

Since 1978, China has been experiencing rapid changes in all aspects of its economic system. From 1978 to 1997, China maintained an annual average GDP growth rate of 10 percent, higher than those of any other country in the world did during the same period. (Ma, 2000). Among other key factors contributing to China’s growth performance, one study made by IMF found that during 1979-1994, China’s productivity gains accounted for more than 42 percent of China’s growth and by the early 1990s had overtaken capital as the most significant source of that growth. (IMF working paper 96/75, “why is China growing so fast”). The table below is showing China’s growth performance in the latest four years:

Table 4 China’s economic growth

	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
Real GDP (%)	8	7.8	7.1	8.0
Exports (\$ bn.)	182.7	183.5	194.7	249.1
Imports (\$ bn.)	136.4	136.9	158.7	214.7
FDI (\$bn.)	41.7	41.1	37.0	37.5

Source: The World Bank Group, Country Data Profile.

Another issue is that foreign trade has grown very rapidly. And tracing back to the earlier period, from US \$20.6 billion in 1978 to more than US\$ 325.1 billion in 1997, during the nineteen years foreign trade grew fifteen fold, with an average annual rate of growth of more than 16 percent. (Yabuki and Harner, 1990).

#### 4.2.1 Pressing Asia

Nowadays the evolving economic relationship between China and other Asian countries become a topic of significant interest. Compared to other Asian countries, according to Morgan Stanley &Co., firstly, China has a deflationary-based cost structure, as a result of a competitive labor force in almost perpetual surplus. As different parts and sectors of the Chinese

economy progress through the value chains, the less dynamic Southeast Asia could end up stuck in different segments of the chains and lose economic battle to newer parts or sectors of the Chinese economy. China can cater to different MNCs in search of different parts of the value chains. Second, China's vast market could act as a magnet to attract foreign investment, as MNCs not only look for cost-savings but also for a market in which to sell their products. (MSDW, Global economic forum, November 6, 2001). More importantly, the quality of Chinese exports is rising rapidly, as China's export structure has shifted rapidly towards electronics and machinery goods and away from primary goods. This suggests that Chinese exports were climbing up the value-added ladder fast, challenging even exports from Japan. These challenges can be seen in China's trade surplus with the US, which has surpassed Japan's since last year. (Standard Chartered Bank Global markets, Hong Kong). The recent rise in Japanese protectionism mirrors Japan's fear about China's competitive threat and resulted in the recent trade war between Japan and China.

Despite being outside the WTO and without currency devaluation during the Asian crisis, Chinese exports recovered sharply after the regional shock. Crucially, China's US export market share has risen to 24 % of US imports from the Pacific Rim from less than 20 % in 1997, while currency devaluation was unable to prevent ASEAN countries' market share from falling. Therefore, Southeast Asia needs to begin its economic restructuring and launch a new development strategy without delay. Competing in mass manufacturing with China is not a viable long-term option. The speed of industrialization in China, to a large degree, will dictate the speed of shrinkage in manufacturing in Southeast Asia. (Morgan Stanley & Co., Global economic forum).

#### 4.2.2 Engine for Growth and Investment

Nevertheless, the emergence of China's economic growth will also benefit Asia's growth by being a source of demand. As a percentage of GDP, China absorbs as much imports from Asia as Japan. China has also been running a trade deficit with Asia since 2000. This trend is likely to continue as WTO

opens more doors for Asian exports to China, whose import appetite will also grow under rising income growth and demand for industrial upgrading. Contrary to common perceptions, China has not gained foreign direct investments at the expense of the rest of Asia. In fact, FDI inflows to Asia have risen along with inflows to China. (Standard Chartered Bank Global Markets, Hong Kong). The recent agreement reached by China and ASEAN on free trade zone has reflected this beneficiary relation between the two regions.

## **5. Banking industry in Hong Kong and Singapore**

If we take the size of individual economy into consideration the relative importance of bank assets in relation to gross national product (GNP) can be analyzed. This measure is used to gauge the degree of financial depth in an economy (Gardener and Molyneux). However, the data we are looking through are all related to gross domestic product (GDP) instead of GNP. GDP is defined as the monetary value of all the goods and services produced by an economy over a specific period. It includes consumption, government-purchases, investments, and exports minus imports. GNP is an economic statistic, which includes GDP plus any income earned by residents from their overseas investments, minus income earned within the domestic economy by overseas residents. We feel in our study GDP is more appropriate ratio. The size of one country's banking industry, or financial depth of the economy, is more related to the whole strength of that economy, which is reflected more precisely by GDP.

### **5.1 Size, Structure and Profitability of the Banking Industry**

#### Hong Kong

As of the end of December 2000, there were 243 authorized institutions (AIs) in Hong Kong, of which 31 were locally licensed banks, 28 restricted license bank, 60 deposit-taking companies and 124 foreign bank branches. Foreign banks dominated the banking industry in Hong Kong, taking 87% of total authorized institutions in 2000, reflecting that Hong Kong's banking

industry is very open to foreign investment. The table below shows the change in the number of authorized institutions over recent years in Hong Kong (HKMA, annual report 2000).

Table 5 Number of Authorized Institutions in Hong Kong at Year-End

	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>
Licensed banks	31	31	31	31
Restricted license banks (RCLs)	39	35	33	28
Deposit-taking companies (DTCs)	113	99	71	60
<b>Locally incorporated AIs</b>	183	165	135	119
<b>Foreign bank branches</b>	178	168	150	124
Total	361	333	285	243

Source: HKMA

The main difference between the licensed banks and the RCLs and DTCs is the minimum amount and maturity term of deposit they are allowed to take. Only licensed banks are allowed to offer savings and checking accounts. Both domestic and foreign financial institutions may apply for a license subject to minimum asset requirement. Authorized institutions have continued to decrease in 2000. The reasons can be summarized in, according to KPMG (Hong Kong) Banking Survey Report (2000), that consolidation of overseas banks and financial difficulties in parent banks cause some to withdraw from overseas markets. The wave of consolidation in Western Europe has brought down the number of foreign bank branches and their related DTCs in Hong Kong, with prominent examples such as the merge of Banque Nationale de Paris with Banque Paribas, the take-over of Credit Commercial de France by HSBC, and smaller mergers and acquisitions

among Italian and Spanish banks. An even stronger factor has been the consolidation of banks in Japan, Malaysia and Indonesia, due to restructuring aimed at solving asset quality problems. Consolidations have until recently been slow in coming given the structural issues at stake in the Hong Kong banking industry. Several mergers and acquisitions have now taken place: Standard Chartered buying Chase Manhattan's credit card business, Bank of East Asia taking over First Pacific Bank, Bank of China merging its Hong Kong and Macao operations with its 12 sister banks and more recently, DBS of Singapore taking over Dao Heng Bank from the Guoco Group and Standard Bank of South Africa buying Jardine Fleming Bank from JP Morgan Chase. (KPMG).

Table 6 The ten top locally incorporated banks in Hong Kong (2001):

<b>Ranks</b>	<b>institutions</b>	<b>Assets USD millions</b>	<b>Profits USD million</b>	<b>ROA (%)</b>	<b>ROE (%)</b>	<b>500 Rank</b>
1	Hong Kong & Shanghai Bank	225,894	3,328.8	1.5	31.0	14
2	Hang Seng Bank	64,203	1,283.8	2.0	24.7	32
3	Bank of East Asia	22,737	239.9	1.1	12.6	93
4	Dao Heng Bank	18,202	221.1	1.2	14.0	111
5	Nanyang Commercial Bank	10,911	127.8	1.2	9.3	160
6	Wing Lung Bank	8,395	129.6	1.5	14.8	180
7	Shanghai Commercial Bank	8,387	138.7	1.7	12.4	181
8	CITIC Ka Wah Bank	7,264	68.2	0.9	9.3	202
9	Wing Hang Bank	6,991	115.5	1.7	16.6	204
10	Pao Sang Bank	6,218	119.7	1.9	9.8	219

Source: Financial 500, Asiaweek

Compared to commercial banks in Europe, North America and Japan, banks in Hong Kong generally have the same pattern as in terms of profitability: as with increase in size, the profitability tends to increase as well, particularly in ROE. However, the result is not so straightforward, maybe due to the data is only individual banks, rather than the average as in The G10 Report.

Hong Kong's largest local bank, HSBC, has performed very well in ROE ratio, compared to the same sized banks in Europe, North America and Japan. Indeed, the top Hong Kong banks have better ROE than that of The G10 banks, maybe due to the well-developed banking industry in Hong Kong.

## Singapore

As at October 2001, there were 132 commercial banks in Singapore, only eight of which were locally incorporated banks. We cannot find the number of changes over consecutive years, either on MAS's database or others. The table below is a description of the structure of Singapore's banking industry.

Table 7 The structure of banking industry in Singapore  
October 2001

Commercial banks	132
Local banks	8
Foreign banks	124
Foreign full banks	23
Restricted banks	19
Offshore banks	82

Source: MAS

Foreign banks in Singapore have occupied 94 percent of total commercial banks, higher than that of Hong Kong. There are three categories of commercial banks in Singapore: full banks, wholesale banks (restricted banks), and offshore banks. All local banks are full banks. The difference between full banks, restricted banks and offshore banks depends on the type of customers, whether non-bank customers or resident individual, and on the amount. This classification is closely related to the level of development of financial market. We will talk about it again when proceeding to banking regulatory framework.

Table 8 Local banks in Singapore (2001):

<b>Ranks</b>	<b>institutions</b>	<b>Assets USD million</b>	<b>Profits USD million</b>	<b>ROA (%)</b>	<b>ROE (%)</b>	<b>500 Rank</b>
1	DBS	64,982	802.1	1.2	13.2	31
2	United Overseas Bank	38,304	527.2	1.4	13.5	56
3	Overseas- Chinese Banking Group	34,484	485.1	1.4	10.3	63
4	Overseas Union Bank	26,915	314.8	1.2	10.6	79
5	Keppel Talee Bank	15,007	174.1	1.2	10.8	131
6	Industrial & Commercial Bank	2,229	18.2	0.8	4.1	347
7	Far Eastern Bank	411	5.0	1.2	7.2	447
8	Bank of Singapore	220	7.7	3.5	4.3	483

Source: Financial 500, Asiaweek

Banks in Singapore are relatively smaller than those in Hong Kong. The sum of all eight Singaporean local banks is still smaller than that of HSBC, the largest one in Hong Kong. To put it another way, the banks in Hong Kong have displayed various kinds of size, ranging from the biggest player with US \$226 billion to small sized one with several billions assets, or even much smaller. The various sizes of banks in Hong Kong could result in the diversification of banking industry, with big players employing fully the scale of economy and smaller players seeking unique market niche. Second, compared with the performance of Hong Kong's banks, banks in Singapore performed relatively poor. Even though we cannot be sure that the size of the bank is the positive link to its profitability, it is quite obvious that the

bank's size is very important in today's banking industry, particularly in the case of very open economy like Hong Kong and Singapore.

Efficiency of banking sector can also be described as follows:

Table 9 Efficiency of the banking system, 1999

	DTIs per million persons	DTI branches per million persons	DTI assets ('000 US\$ per person)	Number of DTI staff per branch
Hong Kong	42	261	129	44
Singapore	69	160	219.2	61
Japan	5	180	-	23
United Kingdom	9	242	-	25
United States	79	288	-	26

Source: BIS, the banking industry in the emerging market economies: competition, consolidation and systemic stability. 4 August 2001.

Note: DTIs: deposit-taking institutions, which including commercial banks, savings and various type of mutual and cooperative banks, and similar intermediaries such as building societies, thrifts, savings and loan associations, credit unions, post banks, and finance companies but excluding insurance companies, pension funds, unit trusts, and mutual funds

It is noticed that Singapore has more DTIs per million persons and DTI assets per person than those of Hong Kong, due to Singapore's 8 times of its assets of DTIs as GDP and its less population. This is once again emphasizing the heavier concentration of Singapore's banking industry. However, if we consider competence ratio, explained by DTI branches per million persons and number of DTI staff per branch, we can reach the conclusion that banks in Hong Kong are more competitive than Singapore's. Still, there is much room for banks in Hong Kong and in Singapore to improve their efficiency when considering number of employee per branch, compared to that in Japan, UK and US.

## 5.2 Comparisons

The IMF Country Report No. 01/146 compared the size of banking industry in Hong Kong and Singapore to some developed countries. Although it was done at 1999, it should show us a rough picture of banking industry in these two economies.

Table 10 Banking system assets and external liabilities (End-1999)

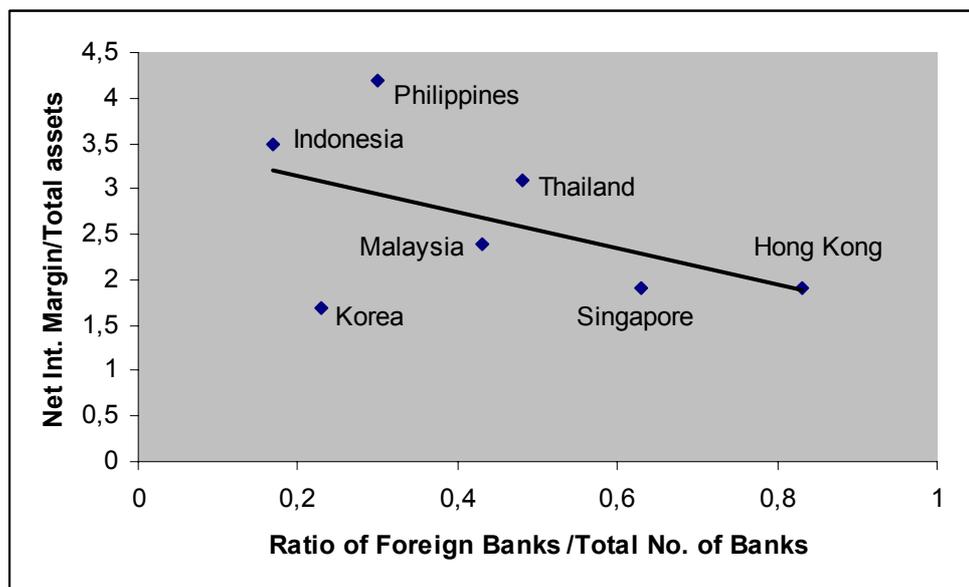
	<i>Total assets</i>	<i>External assets</i>	<i>External liabilities</i>			
	In US\$ bn.	In percent of GDP	In US\$ bn.			
			In US\$ bn.			
			In percent of GDP			
Hong Kong	839	528	476	299	372	234
Singapore	677	800	419	495	417	493
United States	5836	63	871	9	1103	12
United Kingdom	3962	275	1817	126	1894	131
Japan	7242	166	1174	27	542	12
Germany	5602	266	871	41	873	41

Source: IMF Country Report 01/64

Hong Kong bank assets are a larger share of the GDP than even bank-intensive advanced industrial economies such as Germany. However, Hong Kong banks' assets are a smaller share of GDP compared to Singapore's. Banks in Hong Kong and Singapore are both influenced heavily by the changes in the external environment, since external assets and liabilities are several times of their own GDP. It could also reflect that banking industry in both economies is very concentrated, leading to banks providing banking service beyond borders. This highlights these two financial centers' role in the region. But we cannot reach the conclusion only on the basis of this table that Singapore has a more prominent role in the financial center than Hong Kong, because firstly we do not know whether Hong Kong's external assets and liabilities include those related with China; second, the external

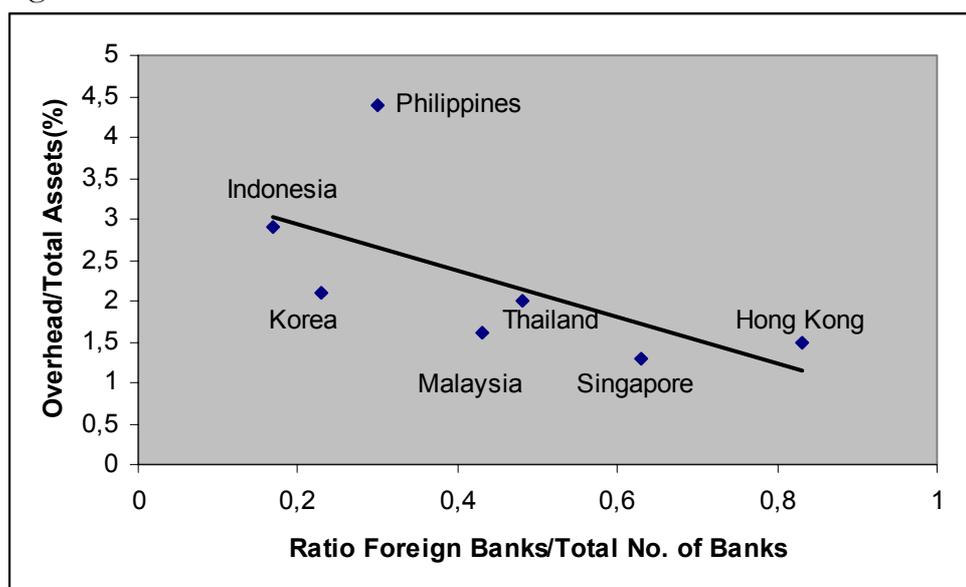
assets and liabilities of Japanese banks have a smaller share of its GDP, compared to Hong Kong's and Singapore's, but this can not deny that Tokyo is obviously the global financial center; third, the smaller share of external assets and liabilities of Hong Kong banks might suggest that banking industry in Hong Kong is more competitive and more attractive in terms of profitability. Therefore, we have to go further to look into the banking industry in Hong Kong and Singapore.

Figure1



Source: Stijn Claessens and Tom Glaessner (1998), *Internationalization of Financial Services in Asia*, the World Bank. Demirguc-Kunt and Huizinga (1997) for net margins and overhead figures.

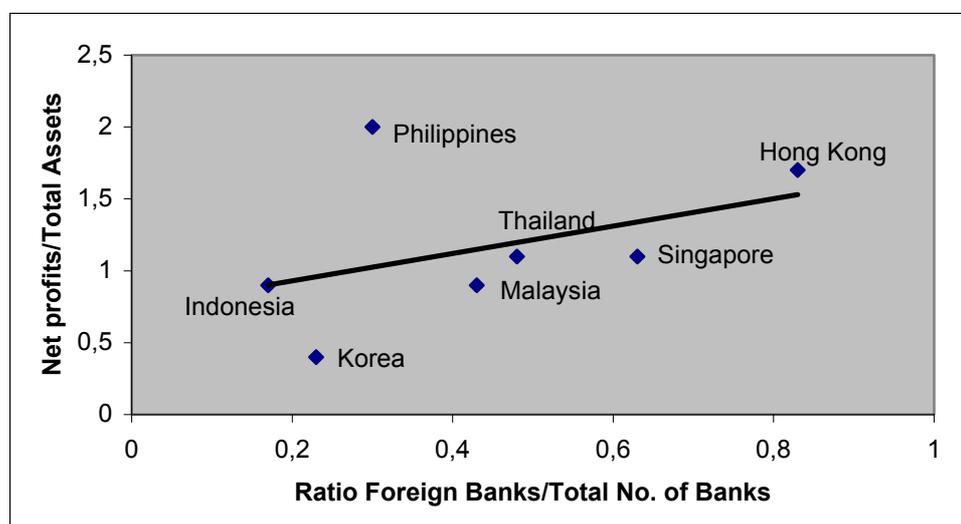
Figure 2



Source: Stijn Claessens and Tom Glaessner (1998), *Internationalization of Financial Services in Asia*, the World Bank. Demirguc-Kunt and Huizinga (1997) for net margins and overhead figures.

Figure 1 and Figure 2 indicate that there exists a negative relationship between net interest margins and the share of foreign banks (in numbers). The Philippines has the highest net margin and little foreign bank presence in terms of number of banks. Hong Kong and Singapore score high on foreign bank presence and low on net margins and overheads. This could be explained through the fact that when more foreign banks compete in the market of deposit taking and lending, interest margin tends to reduce, forcing domestic and foreign banks to develop their fee-based business. Therefore, there is the incentive to diversify and provide a wider range of non-interest related products and service when one country's banking industry becomes more open, as in the examples of Singapore and Hong Kong.

Figure 3



Source: Stijn Claessens and Tom Glaessner (1998), *Internationalization of Financial Services in Asia*, the World Bank. Demirguc-Kunt and Huizinga (1997) for net margins and overhead figures.

Profitability has a positive relationship with foreign banks' presence, as shown by the figure above. Based on the analysis just now, as banks in the more open banking environment, with decreasing overhead cost, their profit will rise, despite low net interest margin. It seems that in such environment, banks can become more financially innovated and generate large amount of fee-based income offsetting lower interest income. And since the 1990s, the interest rate tends to maintain a lower level all over the world, so it is necessary and reasonable for banks operating in free and open market to be characterized by higher profitability.

### 5.3 Analyses

Differences in banking industry between Singapore and Hong Kong are obvious: banks in Hong Kong have larger size and higher profitability than banks in Singapore do. To put it another way, we could say that banking industry is more well-developed in Hong Kong than in Singapore. Clearly,

size and profitability have some kind of close relationship. In the case of Singapore, despite DBS already as the largest bank in its home market, it is a small player even by the standards of Asian market. Another explanation would be the openness of banking industry. From the previous study, we get the information that more openness of the market, more profit the bank will have. However, according to MAS, foreign banks in Singapore already reached 94%, 7% higher than that of Hong Kong, but banks in Hong Kong still have stronger profitability. It is true that when compared to other Asian countries, Hong Kong and Singapore have more foreign banks as the percentage of commercial banks, is this reason justified their higher profitability? If so, how can we explain that the Hong Kong banking industry, with relatively less foreign banking presences, have a higher profitability than those in Singapore? We feel here the openness of one country's banking industry has much to do with regulatory framework and government intervention, those of which can not be fully represented by the numbers of foreign bank's presence. With regard to our research question, some part of the explanation can be derived from our analyses above. Seeing it from the industry's perspective, just like other companies or banks from other countries coming to Hong Kong, Singaporean banks go to Hong Kong in pursuit of higher profit and larger size of economic scale, which can be achieved in a more free, open and promising market. China's entry into the WTO has shown this kind of prospect and has opened huge opportunities in this aspect. We will return to this shortly.

## **5.4 Regulatory Framework and Government Policy**

The differences in size, performance and profitability of the banks in Hong Kong and Singapore can be derived from the divergences in two economies' regulatory framework and the role of government.

### **5.4.1 Different Approaches**

We discussed the role of the government in economic development for Singapore and Hong Kong in previous sections. The Singaporean government has actively promoted the economic development to serve the

best interests of the nation while the Hong Kong government has maintained its involvement as minimal as possible provided the economy goes well as it is. These different approaches are also reflected in supervision of financial sector, which has led to, in academic studies, much more discussion of the role of the government in Singaporean model than that of Hong Kong. In the latter, people have witnessed previous studies focused on market discipline and corporate governance.

The Monetary Authority of Singapore is a unique organization, that is, it is the only institution in the world that combines responsibility for monetary policy with supervisory oversight of the entire financial sector, including banking, insurance and securities. In addition to the two tasks mentioned above, MAS has the task of promoting the development of Singapore as an international financial center.

The goal of the monetary policy for MAS is to keep a low inflation by keeping a strong Singapore dollar. MAS believes that domestic inflation in Singapore was largely determined by changes in foreign prices and the exchange rate, given the nature of Singaporean economy. Therefore, MAS maintained an explicit policy of not encouraging the internationalization of the Singapore dollar. It limited the extension of bank credit for the Singapore dollar to non-residents except for economic activity.

From the beginning, MAS's approach to supervising the financial sector was centered on a strict admission policy, high prudential requirements, and rigorous enforcement. This approach helped win credibility and market integrity, which are vital to any financial center, but this approach has been criticized as well. Prudential standards in Singapore have been thought far more conservative than most anywhere. Comfort letters are required stipulating that head offices will meet liquidity or capital shortfalls of their offshore affiliates. Strict consultative procedures with MAS have guided financial transactions and activities. MAS would issue notices stipulating what activities were permitted. MAS would also regularly monitor bank loan files, accounts and transactions and internal controls. Furthermore, the authorities were unwilling to allow untrammelled competition and growth in

the financial sector. New types of financial activities typically required MAS approval. The government's heavy control has slowed capital market development and hampered financial innovation. Its capital market, including fixed income and equity market and the fund management industry is less developed and has played a smaller role in contributing to Singapore's financial growth (The IMF, Country report No. 00/83, *Singapore: Selected Issues*, July 2000).

MAS's third responsibility was to promote the development of the financial industry. The government took advantage of opportunities to develop Singapore as a regional financial center. Singapore had a time zone advantage, bridging the gap between the closing of markets in the US and the reopening of business the next day in Europe. Its good infrastructure and well-placed location served as a point of intermediation for fund flows in Southeast Asia. Among other achievements, the establishment of Asian Currency Units (ACUs) has been the most successful. MAS started permitting banks to establish ACUs to accept non-Singapore dollar deposits. This paved the way for the creation of the Asian Dollar market, the counterpart of the Eurodollar Market in London. The government abolished withholding tax on interest income earned by non-resident depositors and introduced a low tax rate for offshore income. These measures contributed to the further growth of ACUs market. Today, Singapore is the fourth largest foreign exchange market in the world.

For years, Hong Kong had no central bank and was reluctant to introduce prudential standards. However, banking sector problems in the 1980s, the stock crash in 1987 led to the gradual introduction of prudential regulations and the establishment of the Hong Kong Monetary Authorities (HKMA). In contrast, Singapore began with high prudential standards and gradually relaxed them to establish a level playing field for local banks (IMF, Country report No. 00/83, *Singapore: Selected Issues*, July 2000). Therefore, except for HKMA'S oversight of financial sector, good policies, market discipline and corporate governance have also played very important roles in Hong Kong's banking sector.

Hong Kong has a modern regulatory system, a strong bankruptcy law, and efficient enforcement procedures. The Hong Kong legal system for debt recovery is tailored after the English legal system, which provides strong protection of creditor rights. Prudential regulations and accounting standards in Hong Kong have been continually upgraded. A well-developed equity market is among the largest in the world, with the market capitalization of the Hong Kong Stock Exchange was 377 percent of GDP at the end of 2000 (IMF, Country report IMF, *People's Republic of China-Hong Kong Special Administrative Region, Selected Issues and Statistical Appendix, No. 01/146*, August 20001).

Hong Kong has a tradition of conservative banking practices and strong market discipline. Banks have historically been prudently run and profitable, with high returns on equity and healthy interest margins. Banks were well capitalized, with high liquidity ratios and good asset quality. This provided them with the necessary cushion to absorb unexpected shocks. There are 19 local banks and bank-holding companies, regularly followed by analysts, representing 83 percent of the assets of all local banks.

There are no government-owned banks and no direct lending in Hong Kong. The monetary authorities have repeatedly made public statements that they will only act as a lender of last resort in cases where a bank failure threatens the stability of the system, and will not intervene to rescue individual banks. Large banks effectively acted as a lender of last resort and took over small ailing banks.

Relatively low corporate leverage was a key factor contributing to the resilience of Hong Kong. Compared to Asian countries, the United Kingdom, and the United States, Hong Kong has the lowest debt-to-equity ratio, the lowest total debt-to-asset ratio among the Asian countries, and one of the highest coverage ratios, which is measured as profits to interest expenses.

Reporting standards and transparency of the financial condition of banks are the best in the region. Good accounting standards and disclosure rules can

improve transparency, mitigating information problems inherent in financial intermediation, and enhance market discipline.

The dominant banks in Hong Kong were sophisticated international financial institutions with diversified portfolios and good risk management systems. They were in a better position to respond to an unexpected liquidity shock than the local banks in other countries in the region.

#### 5.4.2 Responses to Global Trend and the Asian Financial Crisis

Global trends can be summarized as that financial markets becoming globalized; cross-border capital flows are larger and faster; financial institutions are consolidating and restructuring on a massive scale; and new and complex financial products are emerging, driven by technology and market pressures.

Asia's financial crisis exposed significant shortcomings both in the region's financial system and in corporate financial structures. A heavy reliance on bank debt along with substantial institutional weakness-inadequate supervision, substandard corporate governance practices, weak accounting and disclosure standards and poorly defined legal rights-are widely cited factors contributing to the crisis. Risks were heavily concentrated in the banking system (IMF Country report No. 00/83, *Singapore: Selected Issues*, July 2000).

In reply to these challenges, MAS and HKMA have introduced measures reforming their banking industry. Despite resulting in the less developed capital market, Singapore's carefully controlled strategy in financial sector has been cast some doubts in that as global competitive forces are speeding financial innovation and capital flows faster than regulators can keep up, and when capital market size and liquidity have grown so critical, Singapore may not longer be able to afford this gradual approach. Furthermore, global trends toward financial deregulation that began in the OECD countries in the 1980s and have sharply accelerated in Asia since the 1997 financial crisis, are spurring competition and resulting in consolidation of activities (IMF, Country report No. 00/83, *Singapore: Selected Issues*, July 2000).

The Singapore authorities has been aware of these challenges and unveiled a program of comprehensive reforms. The overarching objective of the reforms were to meet those challenges and overcome the disadvantage of the small size of the domestic market in Singapore and to compensate for the lack of a natural hinterland unlike other Asian financial centers such as Hong Kong and Tokyo.

The reform is comprehensive but gradual. It covers all segments of the financial sector. The major objectives of the banking system reform are two-fold: first, to continue to gradually open domestic banks to greater competition from foreign banks, and second, for Singapore banks to retain significant domestic market share in this more open environment, as well as to become a significant participants in the regional market. The latter objective is seen as critical to the ultimate survival of Singapore banks, because the domestic base is not large enough to support the growth of banks.

In May 1999, MAS announced a five-year program to liberalize the domestic banking market. The first phase of the banking liberalization included new banking privileges and licenses for foreign banks granted over the period 1999-2001 and was aimed at increasing foreign bank participation and competition in the retail and the wholesale banking sectors. The first package of measures comprised a few main elements. MAS permitted four Qualifying Full Banks (QFBs) to establish up to 10 locations each, relocate their existing branches and share ATMs among themselves. MAS granted 8 new Restricted Bank licenses to banks that wanted to expand their wholesale Singapore dollar business. MAS also gave Offshore Banks more flexibility to lend in Singapore dollars and engage in Singapore dollar swaps, and even wider leeway to 8 Qualifying Offshore Banks (Consolidating and liberalization: building world-class banks, speech by Chairman of MAS, Lee Hsien Loong, June 2001). The next package of measures on banking sector liberalization is scheduled for 2001. The second pack age of measures has three main components: freeing up entry to domestic wholesale banking, enhancing competition in retail banking, and instituting prudential

safeguards necessary for a more liberal banking environment. These measures represent a substantial opening up of the industry. Foreign participation in Singapore's banking industry is expected to increase as MAS liberalize the market. More people will invest and deposit their money with foreign banks.

The global trend has hit Hong Kong with full effects. The increasing intensity of competition has led to the sharp decline in lending margins, particularly on residual mortgages. The interest rate on a 30-year mortgage in Hong Kong is now down to as low as 4.25%, more than 1 percentage point below the yield on an AAA-rated, US Treasury bond. In order to develop new sources of income and achieve better asset-liability management, banks are trying to become financial services provider rather than just banks. The aim is not just to broaden income sources, but also to reduce the volatility of income through more reliance on recurring fees and commissions (KPMG 2000 Banking Survey Report).

Although Hong Kong banks performed relatively well during the Asian Financial Crisis, some weaknesses were also revealed. The lending of many small banks lack modern risk management systems, which producing potential risks of non-performing loans, given Hong Kong's increasing integration with China and a large amount of lending to Chinese firms. Accounting standards and disclosure requirements for borrowers, although the best in the region are still below the best international standards (IMF, Country report *People's Republic of China-Hong Kong Special Administrative Region, Selected Issues and Statistical Appendix, No. 01/146*, August 2001). Therefore, HKMA has embarked a series of reforms on banking sector. Among other things, HKMA updated and added interim disclosure requirement for local AIs in terms of geographical analysis of operating income and advances to customers. HKMA also eliminated inconsistencies between local AIs and foreign AIs on interim disclosure requirements. The most significant reform was the deregulation on the remaining Interest Rate Rules on the deposits with a maturity of 7 days. All deposits interest rates are now determined by market forces. The impacts of deregulation are many: wider choice, lower price, better service and enhanced competition in the industry.

### 5.4.3 Attitudes towards M&A Activities

MAS' perspective states that:

“Banks are a core part of our financial system and affect the stability of the economy. Without a group of strong and well-managed local banks, we risk instability in the event of an economic or market crisis. It is not prudent to rely solely on the foreign banks because in a crisis, banks, which are more deeply rooted in Singapore, will be more likely to act in support of our financial and economic stability. Foreign banks will have large global operations, but the commercial interests of local banks will be more closely aligned with that of the Singapore economy. That is why MAS remains committed to fostering strong local banks with a major share of the domestic market. That is why we need banking consolidation” (Statement by chairman of MAS, Lee Hsien Loong, July 2001).

“Our biggest bank DBS, even after the merger with POSBank, is ranked only 115<sup>th</sup> in the world by asset size. The logic of Singapore's circumstances is inescapable: if we want strong banks, then they have to be big banks, and if they are to be big banks, then they must consolidate. Local consolidation can create viable Singapore banks that can hold their own in the local market without government protection, and compete in selected foreign market. They will not compete globally with the big players, nor can they compete in every product line. .... they (should) will be in a position to expand through careful acquisitions abroad over time, rather than be left with no choice but eventually be acquired by foreign banks.” (Statement by chairman of MAS, Lee Hsien Loong, July 2001).

With respect to any cross-border partnerships, MAS stated explicitly that this kind of consolidation should not result in the foreign partner taking control of a Singapore bank.

The basic attitude the HKMA has towards M&A is that consolidation of the local banking sector is desirable and probably inevitable. The greater stress is laid on the need for smaller banks. HKMA believes that consolidation by means of M&A is an appropriate strategy for these banks, since this strategy would make smaller banks share heavy set-up costs of advanced technology and attract talent. HKMA would provide appropriate incentives for banks to think seriously about consolidation, instead of forcing them to merge or be acquired against their will. HKMA will not erect artificial barriers to acquisition of local banks by foreign banks. HKMA expressed the support that it would be desirable for Hong Kong to retain a core of strong, locally owned banks, as the official of HKMA said that this is something that we would support, but it is not something that we can deliver. Rather, it would depend on whether the local banks can agree on merges among themselves (speech by Deputy Chief Executive of the Hong Kong Monetary Authority, David Carse, 1 June 2001).

## **5.5 Summary**

So far, we have briefly reviewed regulatory framework and strengths of banking industry in Singapore and Hong Kong. In order to make comparisons on regulatory framework in these two economies, we borrowed two figures from the study made by the World Bank on Asian banking study. The first one is provided by Ramos, who studied the quality of the operating and regulatory environment for banks in Asian countries.

Table 11 Comparisons on regulatory framework

	Bank regulatory framework	Bank supervisory quality	Transparency	GS Fragility Score (0=best, 24=worst)	GS CAMELO T scores (1=best, 10=worst)
<b>Hong Kong</b>	Very good, improving	Good, improving	Very good	8	3.5
Indonesia	Satisfactory, improving	Weak, improving	Satisfactory	15	4.6
South Korea	Weak, improving	Fair	Fair, improving	18	N/A
Malaysia	Satisfactory, improving	Weak, improving	Satisfactory	15	4.5
Philippines	Good	Fair	Satisfactory	13	3.7
<b>Singapore</b>	Very good	Very good	Poor	7	4.0
Thailand	Weak, improving	Weak	Improving	22	5.2
India	Satisfactory, improving	Fair, improving	Fair, improving	11	5.8

Source: BIS (1997), Goldman Sachs (1997a and 1997b)

Goldman Sachs CAMELOT Score for domestic banks only. Weightings for calculation of overall score: 25% for asset quality; 20% for management; 15 for capital adequacy; 15 for earnings; 5% for liquidity; 15 for operating environment; 5% for transparency.

He ranks bank supervision quality from very good and improving for Hong Kong to weak for Thailand. He also classifies the degree of transparency and the quality of disclosure, from very good for Hong Kong to poor for Singapore. Ramos provides an indicator of the overall fragility of Asian systems: fragility. Here he ranks Hong Kong and Singapore as most solid, and Thailand as the most fragile. His CAMELOT indicator (capital, assets,

management, earnings, liquidity, operating environment, and transparency) for domestic banks' qualities varies similarly, from Hong Kong as the best, to India as the worst. From this table, we have seen that Hong Kong and Singapore are both similar strong on institutional environmental performance, except for transparency.

The other table is used to analyze barriers to the free flows of financial services. These barriers can be separated into entry (or market access) and lack of national treatment barriers, and the limit on the cross-border provision of financial services. The table summarizes the degree of entry barriers as of the end of 1996. The indicator weighs the various types of barriers (right of establishment and ownership, limits on business activity, the ability to establish branch offices and ATMs, restrictions on lending, universal banking authority, and residency requirements). The table also provides both current barriers as well as the degree to which countries have already committed themselves to opening up.

Table 12 Degree of openness indices in banking sector  
(1 most closed, 5 most open)

	<u>Commitment</u>	<u>Practice</u>
<b>Hong Kong</b>	4.2	4.75
Indonesia	3.15	3.2
South Korea	1.1	1.7
Malaysia	2.4	2.4
Philippines	2.8	3.35
<b>Singapore</b>	2.25	2.5
Thailand	2.95	2.85
India	2.7	2.25
Average	2.69	2.88

Source: Stijn Claessens and Tom Glaessner (1998), Internationalization of Financial Services in Asia

Hong Kong is almost completely open for all financial services while Korea is virtually closed. Singapore in this aspect lags behind Hong Kong.

To summarize our discussion on banking industry in Hong Kong and Singapore, we would highlight the following points. First, differences in size and efficiency in banking industry between Hong Kong and Singapore can be traced back to the difference in regulatory framework and the role of government. Hong Kong's more open and free market environment have resulted in large banks and well-developed industry. This conclusion is also in line with the theories we discussed in our previous section. One thing we should note that is it might not be meaningful to say which approach is preferable to the other, otherwise there is no need for the establishing of HKMA, nor the need for MAS to relax controls gradually. They have different starting points. For Hong Kong, prudential regulations have been gradually introduced while Singapore began with high prudential standards and gradually relaxed. This is the fundamental difference when we compared these two economies and its banking industry. And this is also the background for us to answer what motivates Singapore banks to go to Hong Kong.

Second, from the perspective of a financial center's functions, a financial center consists of a high concentration of financial institutions and underlying markets that allow transactions to take place more efficiently than elsewhere. Financial activities also tend to be drawn to locations with high volumes of information flow from trade or other commercial activities. Path dependence and scale economies have been identified as key determinants that allow financial centers with an early comparative advantage to sustain it over time and achieve critical mass. (The IMF, Country Report No. 00/83, *Singapore: Selected Issues* July 2000). Looking around the major financial centers in the world, New York, London, Tokyo, they all have their own vast sized economies as hinterland to support and sustain their development over time. These financial centers are always characterized by a large volume of capital outflows and inflows. For Hong Kong and Singapore, China is considered as Hong Kong's extended hinterland, and traditionally Southeast Asia as Singapore's. However, the relationship between Hong Kong and China is qualitatively different from that between Singapore and Southeast Asia. And Southeast Asia is smaller than China, both in territory and size of economy. As we have mentioned

before, Hong Kong has integrated increasingly with China's rapid development and has the impetus to transforming its economic structure from this integration. Among other things, China has taken advantage of Hong Kong as a financial center to raise capital to meet its fast economic development. Hong Kong overtook Mainland China as the single largest FDI recipient in Asia, and was also the top source of outward FDI; one of the reasons is that large multinational companies who plan to invest in China have been parking their funds in Hong Kong. So this kind of relationship with China is unique advantage for Hong Kong. Accordingly, banks in Hong Kong also have enjoyed this advantage as well. They know the market situation in China better than anyone else in the world. Most of them have much business relation with customers in China. Some of them even have opened branches and representative offices in China. In this sense, it will be strategically significant for banks from Singapore if they could position themselves and build a base in Hong Kong, in the sense of looking forward to tapping the potential Chinese market.

Third, when looking at major financial centers in the world, they all have their own large banks, which are competing regionally and globally. HSBC is both largest local bank in Hong Kong and one of largest banks in the world. But Singapore's DBS is still a small player by international standards. Again, the size issue is critical to banking industry in Singapore and its position as a financial center.

If there were no opportunities lying ahead, banks would be reluctantly going to Hong Kong. It is true that the banking industry in Hong Kong is more developed and more open to foreign banks. However, the market is also characterized by very intense competition. The competition has become increasingly intensified due to the global trend, as we discussed before. Unless there exist promising prospects and a potential market to dig into, foreign banks, especially small and medium sized banks have to think over their strategy. Fortunately, China's entry in the WTO has shown the foreseeable future with market openings and opportunities to appear.

## **6. China's Banking Industry**

China's current banking system started in 1949, with the People's Bank of China (PBOC) acting as both a central bank and a unique business bank, including four major business divisions within PBOC. As a part of the economic reform program turning the highly centralized management system into a more decentralized and liberalized one, the reform of banking sector was kicked off in 1979. The PBOC was decentralized and restructured, with key banking functions spun off to four state-owned banks. After years of the banking reform, nowadays, a banking system with commercial banks as the foundation has been established in China. Other than one central bank, as of 2000, there were three policy banks, 104 commercial banks, and a large number of city and rural credit cooperatives, as well as 155 branches and 429 Rep offices of 177 foreign banks. The 104 commercial banks currently account for over 80% of China's total banking assets.

### **6.1 Transition from Policy-Driven to Profit-Oriented**

The policy banks, which were established in 1994 and currently account for 9% of the total banking assets, are intended to assume the policy lending role of the formal state specialized banks. All the commercial banks including four large state banks have shifted toward profit orientation, and are now supposed to have profit maximization as the objective, even though they often have to take some quasis-policy loans due to their wholly or partially state-owned ownership.

#### **6.1.1 Regulatory Framework**

Two major laws governing China's banking sector — The Central Bank Law and The Commercial Bank Law, were enacted in 1995. The Central Bank Law aims to make the PBOC a genuine central bank with both supervision and independence, while The Commercial Bank Law is intended to enable the commercial banks become truly 'commercial'.

### 6.1.2 Ownership Diversification

The four large state commercial banks, as well as the three policy banks remain wholly state-owned banks. But the other 100 commercial banks have all adopted a shareholding ownership structure, even if the state still has a controlling stake in most of them. Among these shareholding banks, 3 of them—SZDB, SPDB and Mingshen have been listed on China stock market since 1991, 1999 and 2000, with 69%, 17% and 70% of public shares respectively. Especially, the Mingshen is a private bank, the only private bank in China, with the entire shareholder including the holders of non-traded shares being private investors.

### 6.1.3 Size and Market Share by Banking group and the Performance

Despite a rapid expansion of the shareholding banks, the 4 state banks still hold a overwhelmingly dominant market share in China's banking sector, accounting for over 70% of the sector's total assets and loans and over 80% of its total deposits. The market share of the shareholding banks is about 10%.

Table 13 Size and market share by banking group

	Total assets by %	Total loans by %	Total deposits by %
<b><i>State banks</i></b>	72.6	71.6	82.2
ICBC	24.3	26.4	30.5
BOC	17.8	14.8	17.4
ABC	15.5	17.3	16.3
CCB	15.0	13.1	18.1
<b><i>Policy banks</i></b>	10.8	14.3	0.4
<b><i>Shareholding banks</i></b>	10.7	8.7	12.3
<b><i>City banks</i></b>	4.1	3.4	4.7
<b><i>Foreign banks</i></b>	1.8	1.9	0.5

Source: Standard Chartered Bank

This table reflects the strength of state banks with a huge capital size and strong business network. However, it also suggests the restrictive banking environment and the biased policies of the government towards the state banks. This restrictive banking environment is particularly damaging to the shareholding banks, as their development is more dependent on business innovations.

*Table 14 The profitability of the industry (in %, 1999)*

	<u>ROA</u>	<u>ROE</u>
<b><i>State banks</i></b>		
ICBC	0.12	2.2
BOC	0.11	2.0
ABC	-0.02	-0.3
CCB	0.25	4.6
<b><i>Shareholding banks</i></b>		
Communications	0.35	6.9
Everbright	0.41	7.4
Merchants	0.59	8.2
CITICIB	0.84	16.0
Mingshen	0.85	17.4
Huaxia	0.59	8.1
SPDB	0.99	16.8
SZDB	1.31	17.8
GDB	0.15	4.2
FIB	0.63	8.7

Source: Standard Chartered Bank

The banking system as whole remains of poor profitability, while the shareholding banks performing much well. In comparison, the shareholding banks are much more profitable, with about five times higher ROE and ROA than the state banks on average.

#### 6.1.4 Foreign Banks in China

As of 2000, 177 foreign banks, including all the top 50 banks in the world, have established banking business in China, with 155 branches and 429 representative offices. Foreign banks currently have a 1.5% market share in China's banking sector in terms of assets and loans. But they account for 40% of China's international settlement business, and 23% of China's foreign currency lendings, while the later is as high as 60% in Shanghai. Foreign banks' main business is foreign currency business with foreign-funded enterprises and a limited number of Chinese enterprises. But 32 foreign banks located in Shanghai and Shenzhen have been granted the license to conduct RMB business. Geographically foreign banks' assets are concentrated in coastal cities, particularly in Shanghai, Beijing and Shenzhen (Standard Chartered Bank, 2001).

Table 15 Foreign banks in China (end-2000)

Number of foreign banks	177
Number of branches	155
Number of Rep offices	429
<b>Total assets (USD bn)</b>	<b>34.3</b>
Share in China's total financial assets (%)	1.51
Share in China's total foreign currency loans (%)	22.7
<b>Total outstanding loans (USD bn)</b>	<b>18.6</b>
Share in China's total outstanding loans (%)	1.51
<b>Total deposits (USD bn)</b>	<b>5.8</b>
Share in China's total deposits (5%)	0.36
Share in China's foreign currency deposits (%)	4.5

Source: Standard Chartered Bank

To establish banks' branches in China, a foreign bank must have established and operated a representative office at least two years prior to application.

Its parent company must have total assets of over \$ 20 billion, and the bank must be headquartered in a country with sound financial supervisory and administrative systems. (China's service sector). Foreign banks still face both heavy entry barriers and hefty business restrictions in China, resulting in the market share of foreign banks in China in terms of assets below 2% despite two decades of banking reform in China.

The market share in deposits is even lower, being below 0.5%, owing to stricter restrictions on deposit business than on loan business for foreign banks, indicating a net creditor role than foreign banks play in China.

Major entry barriers are geographic restrictions and entry requirements, while main business restrictions include customer restrictions (to foreign investment companies and residents largely) and currency restrictions (to foreign currency business largely).

## **6.2 The Weaknesses and Strengths of Chinese Banks**

### 6.2.1 The Weakness of Chinese Banks

The economies of scale. The four state banks all enter top 100 with the ICBC ranking the 10<sup>th</sup>, ABC the 20<sup>th</sup>, BOC the 21<sup>st</sup> and CCB the 32<sup>nd</sup> in terms of capital. But all the shareholding banks are out of top 100 and only four of them enter top 1000, suggesting that these more profitable banks in China be at a disadvantage for the economies of scale.

Table 16 Ranking of Chinese banks in the world

	<u>1994</u>	<u>1999</u>	<u>2000</u>
<b><i>State banks</i></b>			
ICBC	7	6	10
ABC	54	88	21
BOC	30	18	32
CCB	47	65	20
<b><i>Shareholding banks</i></b>			
Communications	155	129	130
Merchants	-	300	222
Everbright	-	-	300
Huaxia	-	-	593

Source: Standard Chartered Bank

## Profitability and productivity

Table 17 International comparison for productivity and profitability (1999)

(USD '000)	Per capita assets	Per capita capital	Per capita profits	ROA (%)	ROE (%)
<b><i>State banks</i></b>					
ICBC	689.8	39.2	0,7	0.12	2.2
BOC	1479.2	72.8	2,1	0.11	2
ABC	352.8	8.9	0,2	-	-
CCB	526.2	15.5	3,2	0.25	4.6
<b><i>Shareholding banks</i></b>					
Communications	1431.6	71.5	4,9	0.35	6.9
Everbright	3802.0	208.0	15,4	0.41	7.4
Merchants	2851.0	145.7	13,7	0.48	9.4
SPDB	2474.0	94.9	26,9	0.99	16.8
SZDB	1375.0	87.6	17,2	1.31	17.8
<b><i>International banks</i></b>					
Standard chartered (2000)	3526.8	219.1	36,6	1.03	16.7
Citibank	3615.9	226.5	50,1	2.2	35.6
Chase Manhattan	5033.9	331.9	82,3	2.07	34
Toky-Mitsbitsi	33489.2	1234.7	8,7	0.56	15
HSBC	3633.7	221.9	49,8	1.4	28
Credit Swiss	12888.7	478.0	55,5	0.91	25
BNP	7233.2	224.7	33,2	0.74	32.9

Source: Standards Chartered Bank

For state banks and shareholding banks, productivity is over five times and over two times lower than for international banking groups, respectively. Profitability is lower by about 10 times for the state banks, and 2 times lower for the shareholding banks.

Assets quality. Since Chinese banks do not officially disclose information on The Non-performing Loan (NPLs) ration and the Capital Adequacy (CAR), it is hard to get the accurate numbers. However, according to the estimates by some analysts, the NPLs ration for the state banks is around 25%-30%, putting the state banks on a risky position as compared with international banks, whose ratio normally below 5%. The state banks are also in a weaker capital position in terms of the CAR ratio than international banks, whose ratio is normally over 10%.

#### International network

Weak international network is a major weakness of Chinese banks in comparison with international banks. This is clearly demonstrated in the fact that foreign banks have already taken 40% market share of the international settlement business in China.

#### Financial products

Basically, Chinese banks are traditional banks, meaning that the interest income has been the main source. The proportion of fee-based income in total revenue was about 15% of while interest income accounted for around 70% in 1999, according to Standard Chartered Bank. The comparison between Chinese banks and international banks on development of Off-balance products, such as guarantees and similar contingent debts, pledges, consulting and management advisement and so on, those of product used by Chinese banks only accounted for 60% of those of international banks. Particularly Chinese bank are weak in the products of pledge and consulting and management advisement.

#### 6.2.2 Strengths of Chinese Banks

The largest competitive edge of Chinese banks, especially the state banks, over foreign banks, is their huge domestic network, which has been established over the years. This is also expected to be a critical factor for Chinese banks to resist foreign banks' penetration.

Other strengths include: long-established customer relationships, the understanding of Chinese market, cultural recognition and government support. Finally, liquidity for Chinese banks is better than most foreign banks in terms of the liquid assets as the percentage of total assets as well as the loan/deposits ratio. This is one of the important arguments for the belief that financial risks are manageable in China despite the high NPLs ratio.

Table 18 Liquidity indicators (1999)

	<u>Liquid assets/total assets</u>	<u>Loans /deposits</u>
<b><i>State banks</i></b>		
ICBC	12.8	82.4
BOC	25.9	84.5
ABC	14.3	100.3
CCB	15.6	86.0
<b><i>Shareholding banks</i></b>		
Communications	27.7	65.1
Everbright	18.1	70.6
Merchants	24.8	63.2
CITICIB	25.4	69.9
SPDB	25.4	63.2
<b><i>International banks</i></b>		
Standard Chartered	7.9	99.3
Citibank (98)	6.1	104.7
HSBC (98)	7.9	92.6
Chase Manhattan (98)	9.7	88.0

Source: Standard Chartered Bank

## 6.3 The Impact of China's Entry of WTO

### 6.3.1 The Content of the agreement of China's Entry of WTO on Banking Sector

We shall take the Sino-US WTO agreement on banking sector as the example, since the US is the first major country reaching the WTO agreement with China, others such as EU, Japan, etc. their agreement similar

to that of Sino-US. Second, the impact of WTO to China's banking sector can be positive and negative. The main positive impact would be that the intensified competition would help Chinese banks to grow up faster towards international standards, by pressuring them to accelerate banking reform and to learn about international banking practices, and also facilitating such reforms and learning processes. This is really what WTO entry means for China.

An overall opening-up of China's banking sector will be phased in 5 years. The Sino-US WTO agreement stipulates that foreign banks will be allowed to conduct all the banking business in China, in both RMB and foreign currencies, with both corporate and residents, for both Chinese entities and foreign entities, and in any place of the country, 5 years after China's WTO entry. This will be phased in by two major steps: the opening-up of corporate banking business in RMB with Chinese enterprises in two years, and the opening-up of consumer banking business with Chinese residents in both RMB and foreign currencies in five years.

### 6.3.2 Different Perspectives

From the foreign banks' perspective. Due to the competitive advantages foreign banks have over Chinese banks, foreign banks in China are expected to achieve an unprecedented presence in coming years. The most prospected business areas in which foreign banks have a strong competency include international business (international settlement and trade finance), RMB fee-based business (cash management, remittance, treasury services, and consulting services, etc.), consumer credit card, private banking and e-banking and so on. For large international banks, they can explore Chinese banks with their full competitive advantage in terms of capital, technology, experience, well-know brand and expertise. For small and medium-sized banks, they might have to merger with each other to become bigger in order to compete in Chinese market. And currently, to establish a branch in China, the parent bank must have US \$20 billion in total assets. For most banks in Hong Kong and Singapore, their banking assets are below this requirement.

To merger is the requirement for both surviving in their local market and seeking opportunities in Chinese markets as well.

From the Chinese banks' perspective. Basically, there are two negative impacts on Chinese banks, particularly on the state banks. First, foreign banks will take good customers away from Chinese banks. Large state-owned companies, listed companies, foreign-funded enterprises, wealthy and young educated people are most likely attracted to foreign banks for their professional services and more broad banking products. Second, similarly to losing customers to foreign banks, the state banks are expected to face a sever pressure on talent draining, particularly the BOC and ICBC, who hold China's most experienced banking staff, many of them with an international exposure being most poorly paid.

For shareholding banks, due to their currently weak position in the Chinese market, they have to choose to go public, to merger or to form joint ventures with overseas banks. Again, in the sense of merger and forming joint ventures with overseas banks, banks from Hong Kong become more attractive, since they have relatively modern management, more international banking practices, and advanced technologies.

### 6.3.3 Summary of China's Banking Industry - Mission Impossible or Crouching Tiger and Hidden Dragon?

China's banking industry is concentrated on the four big state banks, with more than 70% of the industry's total assets. Therefore, the fate of the four big banks will decide upon the rise or decline of China's banking industry.

Presently, the performance of the four big banks in terms of profitability and productivity has been much poorer, even lower than those of other types of Chinese banks. In addition, compared with international banks, Chinese banks exhibit weaknesses in asset quality, international network, service, product, technologies, and corporate governance. Banking environment is overall restrictive and is also biased to the state banks.

Under this context, an overall opening-up of the banking sector by China's WTO entry will bring about very serious challenges to Chinese banks, particularly with the four state banks being heavily hit. Their market share will be expected to decrease sharply, compared strengths and weaknesses of Chinese banks with those of international banks.

It is said that the main positive impact on Chinese banks would be a long term one, which is to force Chinese banks to accelerate banking reform, and hence help them grow up faster towards international standards. However, the critical concern is whether or not Chinese banks can achieve this long-term objective. Chinese banks only have five years to strengthen and update their banking systems before coping with tough competition from foreign banks. During this period, foreign banks also make their preparations for exploring Chinese markets. Some analysts claim that the pace of the foreign banks' penetration, and in turn the degree of the negative impacts on Chinese banks is controllable, given the possibility that some restrictions could be maintained without breaching the WTO agreements as well as the strengths of Chinese banks.

It is difficult to accurately forecast the market share either to Chinese banks or to foreign ones. However, two kinds of results are expected to appear for sure: one is that Chinese banks will lose this battle and the other is that they will survive and rise up from the intensified competition. The analyses above could be the starting point for considering China's banking market in 5-10 years, both for foreign and Chinese banks. In this study, it is also the basis for discussions on the acquisition by Chinese bank in Hong Kong.

## **7. Studies on DBS's and ICBC's Mergers**

According to the measurement of efficiency by The G10 Report, here we attempt to analyze the effects of post-acquisitions, by looking at the changes of financial statements. As for evaluating shareholder value, in our case, it will become relatively difficult, since in the first acquisition, the target bank became delisting in the stock exchange market after the acquisition; for the

second one, the bidder is not listing firm. However, we intend to use data available to analyze the shareholder as much as possible.

## **7.1 DBS' Acquisition of Hong Kong's Dao Heng Bank**

DBS Group is the holding company for DBS Bank, the largest bank in Singapore. DBS Bank offers personal and private banking in addition to enterprise services to small and medium-sized companies. DBS bank has more than 100 branches in Singapore and a banking presence in Thailand, Hong Kong, Indonesia and the Philippines through subsidiaries and associated companies. The Singaporean government owns more than 38% of DBS Group, as of December 2000.

### **7.1.1 Business Objective and Main Strategy**

“The bank’s objective is to seek out opportunities to grow our business and to broaden our reach.” Its slogan is to become the world-class regional bank or the best bank in Asia. To achieve the goals, its main strategy is to make growth through M&A activities. Among its M&A activity, three key mergers laid solid foundation for today’s DBS’s leading position. In June, 1998, the merger with the fifth largest bank in Singapore, POSBank, made DBS have the largest retail banking business with a retail customer base of more than 3.3 million in Singapore. In June 2001, DBS completed its acquisition of Hong Kong’s Dao Heng Bank. Together with its previous presence in Hong Kong, DBS has become the fourth largest bank in Hong Kong. In September 2001, the merger with Vickers Securities created the most formidable security houses in Asia.

Table 19 Key figures of DBS Bank

<u>S\$ (millions)</u>	<u>2000</u>	<u>1999</u>	<u>1997</u>
Total assets	111,228.1	106,464.9	100,037.4
Total shareholder s' funds	10,494.8	108,75.8	9,811.5
Total customer deposits	92,774.1	89,758.9	86,476.6
Net profits after taxation	1,388.8	1,071.8	112.0

Source: DBS's annual report

***What can Dao Heng offer to DBS?*** It is necessary to give some descriptions about the DBS's previous presence in Hong Kong, since DBS already acquired one Hong Kong bank, Kwong On bank, in December 1998. This is the second acquisition for DBS in Hong Kong in just two years.

Table 20 Key figures of Dao Heng Bank and Kwong On bank in 2000

<u>HK\$ in billion</u>	<u>Dao Heng</u>	<u>Kwong On</u>
Total assets	141	32
Total shareholders' funds	12.5	4.5
Net profit after taxation	1.7	0.3
Market value*	26.2	-

Source: Annual report; (1S\$= 4.37 Hk\$)

The market value is from SALOMON SMITH BARNEY ASIA PACIFIC.

- Dao Heng was the fifth largest bank in Hong Kong, with 71 branches and 80 ATMs and a branch and six offices in South of China; Kwong On bank was the thirteenth largest incorporated bank in Hong Kong, with 31 branches and one representative office in China.

- Dao Heng is the third largest credit cards franchise in the market, with more than 700,000 cards issued.
- Only strong and sound technology can support the broad credit card issued base. Thus, Dao Heng has an advantage.

Therefore, by acquiring Dao Heng Bank, DBS has become the first Asian regional bank. This acquisition added up to something unique. It is a true Asian bank with strong foundation in the region's two most important markets, with well-established operations in most Asian countries, and a world-class staff. It is an Asian bank with significant consumer and corporate franchises, and good product-service mix. And it is an Asian bank known for its innovative use of technology and electronic networks, its focus on customers, and its obsession for quality (CEO of DBS, DBS, news release, 2001).

***How much DBS pays for.*** According to DBS's News Release, in April 2001, DBS launched an offer for all shareholders of Dao Heng Bank Group in Hong Kong. There are two options available for shareholders of Dao Heng. The first is that shareholders will accept HK \$60.14 per Dao Heng shares in cash (cash option). The second is that shareholders will get a package of HK \$43.26 in cash and one share in unlisted DBS Diamond Holdings, a special purpose acquisition vehicle wholly owned by DBS (cash and share option). Based on estimated June 2001 book value of HK \$19.6 per share, the purchase price represents a multiple of 3.07 to 3.17 times book value (DBS, news release, April, 2001).

According to DBS's third Quarter financial report, 2001, DBS already completed the acquisition of a 71.6% effective interest in Dao Heng Bank's outstanding shares for a consideration of S\$7,071 million. Goodwill of S\$5,086 million arising from the acquisition is calculated based on the share of the estimated fair value of identifiable assets and liabilities of Dao Heng as S\$1,985 million. The goodwill will be amortized over a period of 20 years from the date of acquisition. The remaining 28.4% of issued shares of Dao Heng will be acquired on December 31, 2002.

From the above, we can conclude that:

- DBS will pay around 3.6 times fair value of Dao Heng 71.6% share, based on the numbers above.
- The total price for acquiring 100% of Dao Heng would be close to S\$10 billion.
- The amortization of goodwill will affect DBS's P&L account with S\$64 million reducing profit per month.

### 7.1.2 Analyzing the Impacts on P/L Account and B/L Sheet

DBS's third Quarter financial report included Dao Heng's, under Singapore Statements of Accounting Standards

Table 21 Impacts on P/L account

S\$m	3 <sup>rd</sup> Qtr 2000	3 <sup>rd</sup> Qtr 2001	Incr/ (Decr)	Dao Heng 3 <sup>rd</sup> Qtr 2001	Incr/ (Decr) excl Dao Heng	2nd Qtr 2001	Incr/ (Decr)	Incr/ (Decr) excl Dao Heng
Operating profit	383	574	49.9	118	19.0	354	62.0	28.6
Amortized Goodwill	-	(64)	-	-	-	-	-	-
Provisions Associated companies	26	(246)	-	(24)	-	(8)	2678.9	2411.3
Net profit before tax	7	22	218.6	4	165.5	19	12.8	(6.0)
Net profit after tax	416	286	(31.2)	98	(54.8)	365	(21.4)	(48.4)
Taxation	(76)	(42)	(44.8)	(14)	(64)	(63)	(32.8)	(56.2)
Net profit after tax	340	244	(28.2)	84	(52.9)	302	(19.2)	(47.0)

Source: DBS 3<sup>rd</sup> financial report

- The net profit after tax reduced by 28.2% and 19.2%, compared with the same period in last year and the second quarter of the year, suggesting the adverse economic situation presently.

- Without including Dao Heng's impact, the ratios will decrease more to 52.9 and 47 respectively.
- However, this comparison may, in our view, exaggerate the role Dao Heng plays, since actually Dao Heng only brought about 20m net profit after tax, instead of 84m, given 64m goodwill amortization associated with the acquisition of Dao Heng. Therefore, if we recalculate, taking the net profit after tax as the example, DBS's net profit after tax for third quarter would be 224, excluding Dao Heng, rather than 160, as calculated from DBS's report.

Table 22 The adjustment of net profit after tax

S\$m	3 <sup>rd</sup> Qtr 2000	3 <sup>rd</sup> Qtr 2001	Incr/ (Decr)	2nd Qtr 2001	Incr/ (Decr)
Net profit after tax	340	224	(34.1)	302	(25.8)

Source: own

Therefore, after excluding Dao Heng's impacts completely, the comparison ratio decreased less than it did in DBS's third report. Indeed, goodwill amortization per month accounts for 77% of the net profit Dao Heng contributed to DBS.

Table 23 Key balance sheet data

S\$'m	3 <sup>rd</sup> Qtr 2000	3 <sup>rd</sup> Qtr 2001	Incr/ (Decr)	Dao Heng 3 <sup>rd</sup> Qtr 2001	Incr/ (Decr) excl Dao Heng	2nd Qtr 2001	Incr/ (Decr)	Incr/ (Decr) excl Dao Heng
Total assets	107,269	147,414	37.4	40044	0.1	156,497	(5.8)	-
Customer deposits	50,797	67,958	33.8	16,076	2.1	69,617	(2.4)	-
Customer loans	78,235	105,835	35.3	21,824	7.4	114,851	(7.9)	-
Shareholders' funds	10,456	11,184	7.0				0.4	-

Source: DBS third quarter financial report, 2001

- Even though including Dao Heng's assets, DBS's total asset decreased by 5.8%, compared to the second quarter, reflecting the current economic downturn, especially in terms of weak demand for customer loans.
- Dao Heng takes around 27% of DBS's total asset. This ratio would be 37% if the denominator excludes Dao Heng's assets. For DBS, acquiring such a relatively big size bank will have a big impact on DBS's capital base. Here, we would like to use Capital Adequacy Ratio (CAR) to measure that. CAR is established by BIS to measure the risk and efficiency of financial systems. According to BIS, CAR is defined as a measure of the amount of a bank's capital expressed as a percentage of its risk-weighted credit exposures, including tier 1 and tier 2 capital (for detail, see BIS's publications). The minimum requirement for the combination of tier 1 and tier 2 must be 8% of total risk weighted assets. During adverse economy, CAR tends to reduce.
- The Monetary of Singapore requires its incorporated banks to keep their total CAR as 12% of risk weighted assets, Tier 1 as 8%. According to DBS officials, the purchase of Dao Heng would be funded largely from existing capital. Released by its report, DBS's

CAR reduced to 14.3% from 17% on June 30, 2001, particularly, its Tier 1 dropping to 9.1 from the second quarter's 11.6%. To put another way, the acquisition of Dao Heng does not seem to serve the maximization of DBS's shareholders value in the near term.

- Considering current downturn economy and further acquisition of Dao Heng's remaining 21.6% of issued share, DBS has to find funding sources, either by bonds issued or equities issued.

In summary, to answer our research question, the motive for DBS acquiring Hong Kong's Dao Heng Bank, firstly, according to the comparison between the banking industry between Hong Kong and Singapore, the higher profitability of Hong Kong market and significant opportunities in China market attract DBS most. Second, to expand operation overseas is in line with the Singapore government's policy. Finally, given the special ownership structure of DBS, that is, the government as the single biggest shareholder and policy-maker and supervisor in banking industry, despite the acquisition in short period not in the interest of the shareholder, it fits the government's policy and guidelines on banking industry and the needs of transformation of the economic structure. Therefore, we argue that the role of the government has been mixed with the motives of DBS's acquisition.

## **7.2 ICBC's Acquisition of Union Bank of Hong Kong**

The profile of ICBC and Union Bank. The Industrial and Commercial Bank of China is the largest commercial bank in China and wholly state-owned, with over 30000 branches nationwide, employing over 500,000 staff and handling the bank accounts of 8.1 million companies. It has six branches, three representative offices and one subsidiary overseas. It ranked the 10<sup>th</sup> by Tier 1 and 18<sup>th</sup> by total asset largest bank in the world in 2000.

The ICBC already has a branch and two subsidiaries in Hong Kong engaged in wholesale and investment banking businesses before its acquisition of the UB bank.

Union bank (UB) of Hong Kong was established in 1964 and listed in 1972. It offered retail and corporate banking and other financial services. UB has 21 branches in Hong Kong and one branch overseas. Before 2000, its largest shareholder is China Merchant Financial holdings with 53.24% of the share issued.

In April 2000, ICBC signed an agreement with China Merchants Holdings on the purchasing over 239.9 million shares of the Union Bank for the price of HK\$ 1.805 billion (US\$ 232 million). The amount of shares involved in the acquisition accounts for 53.24% of the Union Bank's total equities. The purchasing price is HK\$ 7.52 per share.

Table 24 Size comparisons among Hong Kong banks

<u>HK\$</u> <u>mln./1999</u>	<u>UB (1998)</u>	<u>Dao Heng</u>	<u>DBS</u>	<u>ICBC</u>
Total assets	20(22)	132	452	3757
Total loans	12 (15)	65	231	2286
Shareholders' equity	2.4(2.1)	117	381	3071
Total deposit	15 (17)	12	46	176
Net profit after tax	-0.5 (0.033)	1,2	4.6	4.7bn
ROA	-2.68% (0.15%)	0.93%	1%	0.12%
ROE	-22.5% (1.4)	10.6%	10.35%	2.2%

Source: own

After the acquisition, according to the speech by the chairman of ICBC, the ICBC will draw on its own advantages to give full support to the Union Bank in business cooperation, capital raising, management and other aspects, aiming to make the Union Bank a first-class listed bank in terms of technology, business classification, profitability and management.

Seen from the speech above, it can be concluded that the Union Bank is relatively poor-performing bank in Hong Kong, compared with Dao Heng Bank. Why ICBC bought such a poor-performing and small-sized bank? As

we discussed development of China's banking industry, especially the four big state banks have suffered huge non-performing loans and thus their CAR has been on the verge of the minimum requirement. Most of Chinese banks have not been listed on the stock exchange, partly due to the less developed Chinese equity market and partly due to low profitability of these banks. With the entry into the WTO and increasingly intensified competition, one of the ways of reforming banks is to get to be listed the stock exchange, both raising capital and improving its performance by market discipline. Obviously, Hong Kong is the best place for such a purpose.

One of ICBC's intentions is to maintain the listing of the shares in the stock exchange. According to Hong Kong's local regulations, if the stock exchange believes that

- A false market exists or may exist in the shares; or
- There are too few shares (less than 25%) in public hands to maintain an orderly market, then it will consider exercising its discretion to suspend trading in the shares.

Another purpose for this acquisition might be that ICBC wants to position itself in Hong Kong in order to become an international bank. With the openness of China's financial service market, foreign banks will expand their operation into China. As the largest commercial bank in China, ICBC also wants to enlarge its international network and diversify its business. By acquiring the Union Bank, ICBC has provided full range financial service from corporate banking, investment banking to retail banking. As the chairman of ICBC described the size of Union Bank as well as its branch network and diversified customer base offer ICBC a suitable platform to further develop its business in the banking market in Hong Kong.

In August 2000, the Union Bank of Hong Kong changed the name to Industrial and Commercial Bank of China (Asia) Limited. In May 2001, ICBC restructured its banking business by transferring its other banking

assets into ICBC (Asia). Thus, ICBC (Asia) has become the ICBC's flagship in Hong Kong.

### **7.3 More Comparisons.**

Firstly, by size, Dao Heng is much larger than the Union Bank, more than six times by total assets. Dao Heng is one third of DBS while the size of the Union Bank is only fraction of that of ICBC.

Secondly, Dao Heng has 71 branches and 81 ATMs and its present network in China. The Union Bank only has 21 branches and one branch overseas. And Dao Heng has more advantaged technology than the Union Bank due to its small share of credit card business in Hong Kong. Thirdly, after the acquisition, Dao Heng went de-listing in the stock exchange while the Union Bank maintains its listing. The intention of DBS is to acquire 100% of Dao Heng's issued shares and make Dao Heng as the key contribution to the group's growth. For ICBC, the acquisition of the Union Bank and later restructuring its banking presence in Hong Kong is just the beginning of its preparation for an increasingly open and competitive market situation in China. Fourth, despite some differences, ICBC and DBS are all government-controlled financial institutions. This background will influence their decision-making in a direct or indirect way.

We consider DBS's acquisition of Dao Heng more risk-taking while ICBC's is more conservative, given the comparison of size between each other. One of reasons might be that M&A has been the key element in DBS's growth strategy. And it is also the second time for DBS to acquire Hong Kong's bank in two years. For ICBC, despite its large size, it has concentrated on its home market and it was the first time for ICBC and also for Chinese banks to make acquisition in one of intentional financial centers. It is doing things by learning. Therefore, we believe that along with further development of banking sector in China, ICBC and other Chinese banks will be more active in Hong Kong's banking market.

## 8. Conclusions and Future Studies

Based on analyses of banking industry in Hong Kong, Singapore and China and on further illustration of two banks' acquisitions, conclusions will be drawn by linking the empirical study with theories as followings:

### 8.1 Linking the Empirical Study to Theories

#### 8.1.1 Motives for Acquisitions

As for value-maximizing motives, mergers can increase expected future profits either by reducing expected costs or by increasing expected revenues (See Chapter 3). DBS's acquisition seems to be of the nature of value-maximizing, seeing it from the perspective of cost reductions, by acquiring Dao Heng bank, which is 1/3 of DBS by assets, DBS tends to increase its size (economies of scale), enrich its product mix (economies of scope) and enter new geographic market. Seeing it from increasing revenues, it is obvious that the motives of DBS for acquisition in Hong Kong is to allow the bank to better serve large numbers of customers, increase product diversification and so on. And it was the second time for DBS to acquire Hong Kong bank in just two years. The first target Kwong On bank was only 1/4 of Dao Heng, which was the latest acquired bank. Therefore, the acquisition of Dao Heng would have shown very clearly to shareholders and the market the goal of maximization of shareholder value.

However, DBS's share price fell 36% in the past six months, according to some analysts, since the market concerns DBS overpaid for Dao Heng (Financial Times, Nov. 2001). Significant contributions from Dao Heng to DBS group cannot be seen from financial analysis, at least in the short run. The reasons could be partly due to the adverse economic situation and partly due to its overpaid price leading to huge amortization of goodwill. Or maybe technical analysis with numbers seems to be less effective tool to show clear picture of the acquisition. This could be in accord with what The G10 Report's found that the actual motives for mergers are not directly

observable and may differ from those stated by management at the time of merger announcement.

China's ICBC's acquisition looks interesting, since among the reasons for value-maximizing motives, only the motive to allow a firm to become large enough to gain access to capital market or to receive a credit rating more appropriate to ICBC's acquisition was found appropriate. Given the small size of Union Bank of Hong Kong, the acquired bank, which is 1/6 of Dao Heng and less than 1% of ICBC by assets, this acquisition seems to have little to do with economies of scale and scope. Even though the detailed financial analysis on impacts of the acquisition on ICBC's financial statements was not conducted, due to limited access to information, the acquisition of Union Bank was not thought to have much impact on ICBC. Thus, is it the case that ICBC's acquisition is non-value maximizing? Judging from its later restructuring Union Bank as a flagship of ICBC in Hong Kong, ICBC's strategic objective and ambitions in international market were already shown clearly. Therefore, it seems to be difficult to find the evidence of maximization of shareholder value from the financial analysis.

Comparing these two banks' acquisitions, there are some similarities: big banks acquired small banks and two banks are both influenced by the government. Non-value-maximizing motives are more concerned with agency theory, which means the divergence of managers' actions and decisions with interests of shareholders. As for these two acquisitions, it seems that managers have the same motive as the government's. Or to put it another way, it can be argued that the government influenced the acquisition in a direct and indirect way, more or less. Is it the case that government-owned banks or government-influenced banks could avoid the problem of non-value maximization as compared to the non-government-owned firms have? This could be one direction for our future study.

Here the significance of Hong Kong as the position of financial center in Asia and China should be emphasized. Both Singapore banks and Chinese banks feel pressure and are all looking for something, which cannot be

found in their home financial markets. To Singapore banks, they are looking for big size, better profitability and future promising market. To Chinese banks, they are seeking more professional and international banking practice, international network and capital. Hong Kong has provided the things they really want. For banking industry in Hong Kong, its small banks have become one of the attractive targets for large and medium sized foreign banks.

### 8.1.2 Forces Encouraging Consolidation

We generalized three factors in the summary of Chapter 6: the global trend and the Asian Financial Crisis, rapid economic development in China, and China's entry of the WTO. These three factors could be regarded as forces encouraging consolidation, according to the theory used by The G10 Report. To Singapore and Hong Kong, the factor of global trend and the Asian Financial Crisis have already exerted the full effect on their banking industry, which could be reflected by technological advances, deregulation, globalization of the market and shareholder pressure, as summarized by The G10 Report. China's rapid economic development and its entry of the WTO have just begun to witness their impacts. With China's further economic development and increasing integration in the world, people will see more far-reaching impacts.

We have found in The G10 Report an interesting and corresponding example of acquisition of large shareholding in the Latin American financial sector by Spanish institutions. In addition to modernization of economies by host governments in Latin America, reform their banking through deregulation and opening their domestic markets to foreign institutions, there are other supporting factors, which also apply to Hong Kong, Singapore and China.

- *The importance of the common language, historical ties and other cultural factors.*  
In Singapore, Hong Kong and China, they also have the common language, historical tradition and cultural ties.

- *The strong financial solvency position of the acquiring banks, coupled with the need to implement strategies that increase shareholder value.* This is also the same in our study. DBS and ICBC, the largest banks in their own countries, have the financial strength as the acquiring banks.
- *Higher intermediation margins in Latin American banking systems, compared with those of more developed countries.* In our study, the banking industry in Hong Kong is also characterized by higher profitability. China, with its huge market and strong economic growth, is likely to be the target market for profitability growth.
- *Minimal correlation between the economic cycles of Latin America and Spain, which allows some risk diversification.* This also applies to the situation between Hong Kong, Singapore and China. Nowadays, China achieves its high economic growth, which contrasts with downturn economies in Hong Kong and Singapore. Foreign banks could enjoy China's economic growth if they have business there, which could be thought of as the kind of risk diversification. However, it is believed that with globalization and China's integration with the world, there will be much correlation in the economic cycles of the rest of the world and China, producing many benefits than just some risk diversification.

### 8.1.3 Forces Discouraging Consolidation

Among these forces identified by The G10 Report, such as regulations, cultural differences, inadequate information flows that is more about the lack of comparability and transparency of accounting reports, and corporate governance, we shall only discuss regulations, corporate governance and information flows. National culture was already discussed and corporate culture could be regarded as the part of corporate governance.

China still has a long way to go before it becomes a real market economy, despite its entry of the WTO. To Singapore and Hong Kong, we have discussed in the comparison of regulations in Hong Kong and Singapore. Here, we only highlight the protection of “national champion”. In some countries, the government has an explicit role in approving foreign

investment in domestic financial institutions. Government may set high hurdles for foreign buyers attempting to acquire majority stakes, in order to protect domestic enterprises. One example mentioned by The G10 Report is the Norwegian policy of protecting national champions, which was seen as the obstacle to consolidations involving Norwegian institutions by other Scandinavian ones. From previous discussion on banking industry in Singapore, Singapore also has such a policy to protect its “national champion”-DBS. This protection could be seen as regards why DBS had to acquire other banks rather than as the target.

As with corporate governance and inadequate information flows, Asian banking is especially weak in this respect. This weakness was already exposed completely by The Asian Financial Crisis. Banks in Singapore and Hong Kong have relatively good accounting information disclosure and strong corporate governance. This may be one of the reasons that DBS could acquire another big Hong Kong bank in two years. As to Chinese banks, they are still far more behind in these aspects. This backwardness could be seen as one reason that ICBC only acquired such a small bank as Union Bank in Hong Kong, less than 1% of ICBC’s total assets, since it might not be easy for ICBC to handle relative big acquired bank in terms of corporate governance and the process of integration. However, it is believed that this acquisition is a good experiment for ICBC’s future development. And more M&As, involving large sums of money, are expected to be made by Chinese banks in the coming days.

#### 8.1.4 Internationalization of Financial Services

As discussed in the theoretical section, the internationalization of financial services is defined as eliminating discrimination in treatment between foreign and domestic financial services providers and removing barriers to the cross-border provision of financial services (Claessens and Glaessner, 1998). The different pace of internationalization of financial services in Hong Kong, Singapore and China can be seen very clearly in my study, with Hong Kong as the best, Singapore in the middle and China as the least internationalized as regards financial services.

Internationalization also relates to domestic financial deregulation. China seems to take the US approach as the United States over-regulates its domestic market but freely allow foreign firms to enter the local market. When China becomes the official member of the WTO, foreign firms can enter its financial market but still subject to its over-regulations.

As for capital liberalization, this is not a promise or commitment when China enters the WTO. China will continue its capital controls and restrictions on the convertibility of the currency. In our view, it is necessary during this stage of development, since China needs huge capital inflow to spur its economic take-off. Capital liberalization in China is believed as just a time issue.

Changes of banking industry in US and European countries, as mentioned in the Chapter of Introduction, have impacts on and spread to other parts of the world, including Asian countries. Therefore, the process of globalization has involved the participation of all countries, particularly as the catalyst for China's transformation from the largest planning economy in the world to currently the world's largest emerging economy, and to the market economy in the future.

## **8.2 Principal Conclusions**

Acquiring two Hong Kong banks by DBS and ICBC could be looked upon from different perspectives:

The maximization of shareholder value is likely to be the motive for the two acquiring banks, DBS and ICBC. The evidence can be found on the analysis of the two target banks acquired by DBS and ICBC and on DBS and ICBC themselves. However, seen from the financial analysis, there is not much significant contribution to their shareholder value from the acquisition, at least in the short run. Therefore, in our opinion, the maximization of shareholder value is more like a long-term goal for DBS and ICBC. Whether or not it could be realized, it depends on their own performance and some external factors.

While the motive for maximization of shareholder value is not very clear-cut, the external factors or forces seems to play a dominant role in the two acquisitions. Macro economic development, the global trend of banking industry and the Asian Financial Crisis, and the market opening-up and deregulation have exerted different impacts on different countries and also interplayed mutually as well. China's economic development has both provided an increasingly important market and pushed other Asian countries to concentrate on their core strengths. The global trend and the Asian Financial Crisis have forced the advanced economies such as Singapore and Hong Kong to reform and strengthen their banking industry, thus has provided the lessons and experience for Chinese banks to learn from. China's WTO entry as the form of the market opening up and deregulation has provided the opportunities for foreign banks to realize their business objectives. Under this context, largest commercial banks in the region felt pressure at their home market and found the business opportunities as well. In our opinion, these external factors have far more influential impacts on the banks' operation than the internal ones or the banks' own motives. It could be the fact that DBS and ICBC have to go beyond their borders to look for places for their better life, even though they feel reluctant to do it.

Finally, these external forces have also facilitated internationalization and liberalization of financial services industry, which in turn will breed more mergers and acquisitions to appear in the coming days.

All in all, the banking industry to date has experienced significant changes. How to make a balance on adapting to those changes and achieving maximization of shareholder value has been the serious challenge for banks to face.

### **8.3 Suggestions for Future Study**

The research on banking industry is fascinating area, because banks, not merely one economic sector among many, have an impact on all other

sectors through their lending policies; on large numbers of individuals through their deposit-taking function; and on the general financial and monetary condition of an economy (Geoffrey, 1990). Therefore, the direction the researcher can go for future study could be multiple. In our study, initially we planned to conduct the study both from the industry level and from the firm level. However, the lack of information on individual banks only forced us to choose the top-down approach that focus more on the banking industry. So the future study would be more fruitful and insightful if combining well top-down approach with bottom-up approach together. As we mentioned before, our study did not extend much to the banks' functions, such as credit policy, deposit taking and risk management. We feel it would be fruitful if future study can focus more on impacts of consolidation on banks' functions.

In our opinion, the study beginning from macro level on banking industry could generate benefits so that the researcher can get an overview of banking industry and a clear idea of where the research interests and problems exist. Specifically, we think of government-owned or influenced banks as research targets for future study. Judging from the perspective of motives for consolidation, we feel the motives of such banks are different from those of non-government-owned banks.

One of the conclusions The G10 Report presents its empirical study is that impacts of consolidation on banks' efficiency only seems to apply to small sized banks, rather than large ones. In Hong Kong, as the freest economy, there are many small sized banks operating. In this sense, Hong Kong is the ideal place to study banks' performances. Looking beyond the whole region, especially in East Asia, we think it could be one important market field for study of banking industry, other than the US and the EU, since the region has offered rich research targets, including the largest emerging economy, the second largest economy and the freest economies in the world, with almost all kinds companies of different ownership.

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## **Appendix 1-China and WTO**

It is quite necessary to give rough descriptions on WTO and China, due to the significant of China's WTO entry. The following is edited from press release by [www. wto.org](http://www.wto.org).

China and WTO:

The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The agreements have three main objectives: to help trade flow as freely as possible, to achieve further liberalization gradually through negotiation, and to set up an impartial means of settling disputes. The goal is to help producers of goods and services, exporters, and importers conduct their business.

The World Trade Organization on 17 September 2001 successfully concluded negotiations on China's terms of membership of the WTO. "International economic cooperation has brought about this defining moment in the history of the multilateral trading system," said Mike Moore, WTO Director-General, at the conclusion of the meeting of the Working Party on China's Accession. "With China's membership, the WTO will take a major step towards becoming a truly world organization. The near-universal acceptance of its rules-based system will serve a pivotal rôle in underpinning global economic cooperation." Under the chairmanship of Ambassador Pierre-Louis Girard of Switzerland, the Working Party concluded almost 15 years of negotiations with China and agreed to forward some 900 pages of legal text for formal acceptance by the 142 Member Governments of the WTO. Thirty days after China notifies its acceptance of the agreement, China legally becomes a member of the WTO.

As a result of the negotiations, China has agreed to undertake a series of important commitments to open and liberalize its regime in order to better integrate in the world economy and offer a more predictable environment for trade and foreign investment in accordance with WTO rules.

Among some of the commitments undertaken by China are the following:

- China will provide non-discriminatory treatment to all WTO Members. All foreign individuals and enterprises, including those not invested or registered in China, will be accorded treatment no less favorable than that accorded to enterprises in China with respect to the right to trade.
- China will eliminate dual pricing practices as well as differences in treatment accorded to goods produced for sale in China in comparison to those produced for export.
- Price controls will not be used for purposes of affording protection to domestic industries or services providers.
- The WTO Agreement will be implemented by China in an effective and uniform manner by revising its existing domestic laws and enacting new legislation fully in compliance with the WTO Agreement.
- Within three years of accession all enterprises will have the right to import and export all goods and trade them throughout the customs territory with limited exceptions.
- China will not maintain or introduce any export subsidies on agricultural products.

While China will reserve the right of exclusive state trading for products such as cereals, tobacco, fuels and minerals and maintain some restrictions on transportation and distribution of goods inside the country, many of the restrictions that foreign companies have at present in China will be eliminated or considerably eased after a 3-year phase-out period. In other areas, like the protection of intellectual property rights, China will implement the TRIPS (Trade-related Aspects of Intellectual Property Rights) Agreement in full from the date of accession.

During a 12-year period starting from the date of accession there will be a special Transitional Safeguard Mechanism in cases where imports of products of Chinese origin cause or threaten to cause market disruption to the domestic producers of other WTO members.

On the other hand, prohibitions, quantitative restrictions or other measures maintained against imports from China in a manner inconsistent with the WTO Agreement would be phased out or otherwise dealt with in accordance with mutually agreed terms and timetables specified in an annex to the Protocol of Accession.

### **1. Goods**

The conclusion of the negotiations for market access on goods represents a commitment undertaken by China to gradually eliminate trade barriers and expand market access to goods from foreign countries. China has bound all tariffs for imported goods. After implementing all the commitments made, China's average bound tariff level will decrease to 15% for agricultural products. The range is from 0 to 65%, with the higher rates applied to cereals. For industrial goods the average bound tariff level will go down to 8.9% with a range from 0 to 47%, with the highest rates applied to photographic film and automobiles and related products. Some tariffs will be eliminated and others reduced mostly by 2004 but in no case later than 2010.

### **Textiles**

Upon accession China will become a party to the Agreement on Textiles and Clothing and will be subject to its rights and obligations. As for all WTO members, quotas on textiles will end at 31 December 2004, but there will be a safeguard mechanism in place until the end of 2008 permitting WTO Member Governments to take action to curb imports in case of market disruptions caused by Chinese exports of textile products.

### **Agriculture**

China agreed to limit its subsidies for agricultural production to 8.5% of the value of farm output (per Article 6.4 of the Agriculture Agreement). China

also agreed to apply the same limit to subsidies covered by Article 6.2 of the Agriculture Agreement.

## **2. Services**

### **Telecom**

Upon China's accession, foreign service suppliers will be permitted to establish joint venture enterprises, without quantitative restrictions, and provide services in several cities. Foreign investment in the joint venture shall be no more than 25%. Within one year of accession, the areas will be expanded to include services in other cities and foreign investment shall be no more than 35%. Within three years of accession, foreign investment shall be no more than 49%. Within five years of accession, there will be no geographic restrictions.

### **Banking**

Upon accession, foreign financial institutions will be permitted to provide services in China without client restrictions for foreign currency business. For local currency business, within two years of accession, foreign financial institutions will be permitted to provide services to Chinese enterprises. Within five years of accession, foreign financial institutions will be permitted to provide services to all Chinese clients.

### **Insurance**

Foreign non-life insurers will be permitted to establish as a branch or as a joint venture with 51% foreign ownership. Within two years of China's accession, foreign non-life insurers will be permitted to establish as a wholly-owned subsidiary. Upon accession, foreign life insurers will be permitted 50% foreign ownership in a joint venture with the partner of their choice. For large scale commercial risks, reinsurance and international marine, aviation and transport insurance and reinsurance, upon accession, joint ventures with foreign equity of no more than 50% will be permitted; within three years of China's accession, foreign equity share shall be increased to

51%; within five years of China's accession, wholly foreign-owned subsidiaries will be permitted

### China in World Trade

In 2000 China was the 7th leading exporter and 8th largest importer of merchandise trade - exports: 249.2 billion dollars (3.9% share), imports: 225.1 billion dollars (3.4% share). For commercial services China was the 12th leading exporter and the 10th largest importer - exports: 29.7 billion dollars (2.1% share), imports: 34.8 billion dollars (2.5% share).

## **Appendix 2-The List of Some Key Abbreviations**

ABC: Agricultural Bank of China

ACU: Asian Currency Unit

AI: authorized institution

BOC: Bank of China

CAMELOT: capital, assets, management, earnings, liquidity, operating environment, and transparency

CAR: Capital Adequacy Ratio

CCB: China Construction Bank

CITICIB: CITIC Industrial Bank

Communications: Bank of Communications

DBS: Development Bank of Singapore

DTI: deposit-taking institutions

Everbright: China Everbright Bank

FDI: foreign direct investment

FIB: Fujian Industrial Bank

GDB: Guangdong Development Bank

GDP: gross domestic product

GNP: gross national product

HKMA: Hong Kong Monetary Authorities

HSBC: Hong kong and Shanghai Bank Corporation

Huaxia: Huaxia Bank

ICBC: Industrial and Commercial Bank of China

Merchants: China Merchants Bank

Mingshen: China Mingshen Bank

NPL: non-performing loan

PBOC: People's Bank of China

QFB: Qualifying Full Bank

RCL: Restricted license bank

SPDB: Shanghai Pudong Development Bank

SZDB: Shenzhen Development Bank

UB: Union Bank

WTO: the World Trade Organization