Several formal announcements and rumors over the last year indicate that foreign investors—both industry players and financial and private equity investors—are taking an increasingly serious look at the acquisition of minority equity stakes in small and medium-sized commercial banking institutions in China. The serious dispute developing as this article goes to press between Newbridge Capital, Inc. (Newbridge) and certain government shareholders of Shenzhen Development Bank (SDB) regarding Newbridge’s proposed acquisition of such government shareholders’ shares in SDB will only intensify interest in these deals.

These transactions began in 1996 and accelerated in 2001 (see p.20). Market rumors and sometimes opaque announcements continue to circulate regarding other potential minority equity investments by foreign institutions in the likes of the Bank of Communications, Huaxia Bank, China Merchants...
Bank, and China Minsheng Bank—in fact, almost any commercial bank other than the big four wholly state-owned banks: Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China. Foreign investors that have already participated include multilateral institutions like the Asian Development Bank (ADB) and the International Finance Corp. (IFC), financial institutions like Citigroup Inc. and The HSBC Group, and US private equity institutions such as Newbridge, although it is now extremely unlikely that Newbridge’s deal will go through. Rumored new entrants include United Overseas Bank of Singapore, Hong Kong-based Bank of East Asia, and private equity powerhouse The Carlyle Group.

The regulatory environment

No PRC legislation specifically authorizes any of these transactions. Several PRC laws and regulations exist concerning foreign investment in Chinese commercial banks, and rules govern foreign purchases of equity in Chinese companies in private transactions (see p.21). But no law or regulation yet provides a specific legal basis for foreign or foreign-invested entities to purchase stock in Chinese commercial banks organized as companies limited by shares (CLGs) in private transactions, and such investments were prohibited by a 1994 People’s Bank of China (PBOC) notice. Contrast this with foreign investments in Chinese insurance CLGs, which are undertaken in accordance with the China Insurance Regulatory Commission’s (CIRC) 2000 Provisional Regulations on Investment Through Shares in Insurance Companies and 2001 Notice Concerning Standardization of Certain Items in the Absorption of Foreign Investment through Share Purchases in Chinese-Invested Insurance Companies.

Thus, each equity investment in a Chinese commercial bank has been undertaken pursuant to case-by-case approvals of the State Council acting on the advice of China’s central bank and commercial banking regulator, PBOC. The formulation and “imminent” release of a regulation explicitly allowing foreign equity participation in Chinese commercial banking institutions has been a staple of the rumor mill in Beijing and Shanghai for more than a year. With the establishment of the China Banking Regulatory Commission (CBRC), to which the PBOC has ceded supervisory responsibility over commercial banks, the prospects for formal regulations governing these transactions have improved.

What seems certain is that CBRC alone will issue regulations governing these transactions and that the successor to the PRC Ministry of Foreign Trade and Economic Cooperation (MOFTEC)—the Ministry of Commerce (MOFCOM)—will not exercise its authority under the 1995 Several Issues Concerning the Establishment of Foreign-Invested Companies Limited by Shares (FICLS provisions) or play its traditional role as the gatekeeper for all foreign investment. CBRC, like PBOC, will limit aggregate foreign ownership to 24.9 percent in any one entity. PBOC, so far, has also tacitly set a 15 percent limit on ownership for any single foreign investor (although the Newbridge/SDB deal was announced in October 2002 at more than

Newbridge notwithstanding, passive stakes can be a growth activity
financial institutions or integrate them into a global business.

Second, PBOC approvals to date indicate that the “minority” equity interest made available to any single foreign shareholder may be as high as 15 percent, up from 3 to 8 percent in the earliest approvals.

Third, China is beginning to accept foreign direct investment in small Chinese banking institutions that have already listed on the domestic A-share market. Fourth, as confirmed by the 2002 Notice Regarding the Transfer to Foreign Investors of State-owned Shares and Legal Person Shares of Listed Companies and the Citigroup transaction structure, Chinese state institutions are being permitted to sell their existing interests in such banks, not merely suffer dilution as new investors enter the fray. Fifth, and perhaps most significant, PRC central banking regulators seem to be considering allowing certain foreign investors to exercise real management control. The Newbridge/SDB deal originally offered full management control (by contract—now apparently terminated) and board representation for Newbridge.

Why not expand by branching or through FIEs?

Given China’s World Trade Organization (WTO) entry and new arrangements with

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Foreign Minority Investments in PRC Banks to Date

- **China Everbright Bank** has foreign investment from the Asian Development Bank (30.3 percent, 1996) and PRC-invested but Hong Kong-domiciled China Everbright Holding Co. Ltd. (Hong Kong) (20.07 percent, 1997).
- **Bank of Shanghai** has foreign investment from the International Finance Corp. (IFC) (total 7 percent, 1999 and 2001), HSBC (8 percent, 2001), and Shanghai Commercial Bank (Hong Kong) (3 percent, 2001).
- **Nanjing City Commercial Bank** has foreign investment from IFC (15 percent, 2001).
- **IFC and Canada’s Scotiabank** in September 2002 signed a memorandum of understanding under which IFC and Scotiabank would acquire 12.5 percent and 12.4 percent, respectively, of **Xi'an City Commercial Bank (XCCB)**, for a total of 24.9 percent of XCCB.
- **Shenzhen Exchange A-share-listed Shenzhen Development Bank (SDB)** announced in October 2002 that Newbridge Capital Inc. (Newbridge) had negotiated a stake of 18.02 percent in SDB via an investment of new capital and the acquisition of existing holdings from PRC state shareholders. Newbridge would assume management control of SDB through both the establishment of an eight-person “acquisition transition management committee,” which presumably was to evolve into some kind of permanent, Newbridge-appointed executive team, and at the board level.

After months of conflicting rumors, on May 12, 2003, SDB announced that it would not go forward with closing the deal and that it was disbanding the transition management committee. Newbridge responded on the same day with a strongly worded press release in which it stated: “The announcement made today by the Shenzhen Development Bank has no effect on our binding agreement with the Shenzhen government shareholders signed in June of 2002. We expect that the Shenzhen government... to [sic] respect its international commitments and honor its obligations under this binding international contract with us.” Judging from the Newbridge press release, pricing of the equity to be sold by Shenzhen state shareholders (likely tied to reserves and valuation of SDB) is at issue.
- **Citigroup Inc.** announced on January 2, 2003 that it would purchase a 5 percent stake in, and enter into a broader strategic co-operation focusing on the development of a credit card business with, **Shanghai Pudong Development Bank**, through its banking subsidiary, with options to increase its stake to as much as 24.9 percent. The shares were purchased from two state institutions, and the stake was diluted to 4.62 percent when Shanghai Pudong Development Bank issued 300 million new shares days later.
- **PRC shareholder China Orient Group** announced on May 14, 2003 that it had agreed to sell almost 41 million shares in A-share listed **China Minsheng Bank**—reputedly China’s only commercial bank without state investment—to IFC for $23.5 million, giving IFC a 1.22 percent equity interest in the bank. Subject to government approvals, the price of ¥4.70 ($0.57) per share is at a discount to the same day A-share trading price of ¥11.30 ($1.37) per share. Later it was reported that Hong Kong’s Hang Seng Bank will purchase 8 percent of China Minsheng Bank for ¥1.4 billion ($169.4 million).

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respect to the financial sector generally, it may seem strange that foreign banking institutions are expressing such interest in China’s banking sector via minority equity investments in established Chinese banks. As of April 30, 2003, foreign banks had established 148 branches and 9 sub-branches in China, as well as 210 representative offices, and 16 foreign-invested banks and finance companies had been established with 7 branches. Even prior to China’s WTO entry, foreign banks had established strong beachheads in the PRC—with 221 representative offices of foreign commercial banks, 158 foreign bank branches (and 6 sub-branches), and 13 foreign-invested banks and finance companies.

Though WTO entry promised improvements in the regulatory landscape for foreign banks in China, subsequent PBOC regulation has burdened foreign banks with significant constraints on their activities in China. Thus, though geographical restrictions on renminbi (RMB) business by foreign bank branches are to be removed completely by December 11, 2006, foreign banks will still face burdens in establishing branches in China, including onerous representative office seasoning requirements; branch-level capital reserve, liquidity, and deposit requirements; foreign exchange deposit/foreign exchange asset ratio limitations; and lengthy branch application procedures. As a result, many foreign commercial banks realize that it will take a significant amount of time and expense to establish real in-country branch networks and/or obtain the ability to undertake RMB business. Because of these restrictions, and the problems associated with pursuing essentially greenfield joint venture projects, many foreign banks keen to enter the PRC market, and participate in the creation and expansion of a true network and the RMB market, have turned part or all of their attention to minority investments in Chinese banks organized as CLSs.

The advantages associated with minority equity investment as compared with the branching or FIE routes are clear given the above restrictions: a foreign bank investor making a minority investment in an existing Chinese commercial bank will be able to reach a broader range of retail customers more quickly, and its investee bank will not be subject to the same restrictions or requirements. In addition, approvals for branches of the investee bank will be far easier, and the investment will be more liquid (via either the private sale of its stock interest or participation in some kind of capital market transaction). There will also be opportunities to co-brand or jointly market products, such as credit cards. Conversely, the 24.9 percent ceiling limits foreign investors’ interest for the foreseeable future, with attendant constraints on control—absent extensive minority rights or the proposed Newbridge/SDB-type structure.

**State-owned shares and legal person shares**

The announced Newbridge/SDB transaction originally attracted a great deal of attention not only because a foreign investor with a minority equity position was to be granted management control, but also because Shenzhen municipal government-related shareholders were to transfer their equity in the target bank. Reportedly, 16.46 percent of the rumored 18.02 percent to be purchased by Newbridge was composed of state-owned shares or legal person shares held by Shenzhen Investment Management Co., Shenzhen International Trust & Investment Co., Shenzhen Social Security Administration Bureau, and Shenzhen City Construction Development Group Co. From a legal standpoint, the 2002 Legal Person Shares Transfer Notice provided a theoretical basis (and approval track) for such purchases—which had been banned since 1995, at least with respect to the purchase of state shares and legal person shares in Chinese CLSs with listed shares.

But foreign purchasers, whether foreign banks or private equity groups, must also care-

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**Table 1: Pros and Cons of Entry Routes**

<table>
<thead>
<tr>
<th>Item</th>
<th>Foreign Branch and Foreign-Invested Bank</th>
<th>Foreign Minority Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Control</td>
<td>Absolute control over branch or WFOE, potential majority control over EJV</td>
<td>Only minority shareholder rights</td>
</tr>
<tr>
<td>Price of Investment</td>
<td>Capital contribution usually at par value</td>
<td>Negotiable</td>
</tr>
<tr>
<td>Initial Public Offering (IPO, for exit or additional funding)</td>
<td>No PBOC approval precedent; would require restructuring as company limited by shares</td>
<td>Domestic or overseas IPO possible</td>
</tr>
<tr>
<td>Availability for Prospective Entries</td>
<td>Onerous seasoning requirements</td>
<td>Very low requirements</td>
</tr>
<tr>
<td>Geographic Roll Out</td>
<td>Restrictions until December 2006; separate working capital requirements for each branch pose barriers to branch establishment</td>
<td>No restrictions; easy implementation</td>
</tr>
<tr>
<td>Speed of Execution</td>
<td>Up to 14 months for new branch or FIE</td>
<td>Case by case</td>
</tr>
</tbody>
</table>

**NOTES:** WFOE=wholly foreign-owned enterprise; EJV=equity joint venture; FIE=foreign-invested enterprise; PBOC=People’s Bank of China

SOURCE: Nicholas C. Howson and Lester Ross

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**Selected Relevant Regulations**

**Foreign investment in Chinese commercial banks**

- 1995 Commercial Bank Law
- 2001 Regulations on the Administration of Foreign-invested Financial Institutions (superseding 1994 regulations of the same name)
- 2002 Implementing Rules for the Administration of Foreign-invested Financial Institutions

**Rules governing foreign purchases of equity in Chinese companies in private transactions**

- 1995 Several Issues Concerning the Establishment of Foreign-invested Companies Limited by Shares
- 2003 Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors

—Nicholas C. Howson and Lester Ross
fully consider the difficulty of such transactions, given the high approval threshold, and sensitivities concerning valuation, when state shareholders—acting on behalf of “the whole people”—are permitted to sell their interests. Certainly, new investment in a Chinese bank (with a small dilution suffered by existing state shareholders) will be easier to effect and get approved and will provide new and much-needed capital for the target institution. As a case in point, the warring press releases that heralded the demise of the Newbridge/SDB deal indicate that disagreement over pricing between Newbridge and the Shenzhen state shareholders listed above may be the principal reason for the deal’s apparent collapse.

Valuation and pricing

The valuation of a small or medium-sized Chinese bank, and pricing of a minority equity investment in such a bank, can present significant challenges. Potential foreign purchasers must work to understand, to the greatest extent possible, the true situation regarding solvency and asset quality, organization of the bank and its actual network, management and shareholder (or state) interest in operations, CBRC’s view of the bank in question and the bank’s ability to expand operations nationwide, and the web of laws, regulations, and pronouncements that will directly affect the operations of the target bank or the proposed foreign purchaser’s investment.

Table 2: Comparison of Entry Routes

<table>
<thead>
<tr>
<th>Item</th>
<th>Foreign-Invested Enterprises</th>
<th>Domestic Banking Institutions with Foreign Minority Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Foreign-Financed Company</td>
<td>Finance Company</td>
</tr>
<tr>
<td></td>
<td>Finance</td>
<td>EJV</td>
</tr>
<tr>
<td>Limitation of Foreign Equity Interest</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Main Requirements for Foreign Investors</td>
<td>Capital Adequacy</td>
<td>Financial institution</td>
</tr>
<tr>
<td></td>
<td>Assets</td>
<td>$2 billion</td>
</tr>
<tr>
<td></td>
<td>Seasoning/ Representative Office in China</td>
<td>2 years</td>
</tr>
<tr>
<td>Minimum Registered Capital (for foreign exchange transactions with foreign customers)</td>
<td>¥100 million</td>
<td>¥300 million</td>
</tr>
<tr>
<td>Prudential Requirements</td>
<td>30% of working capital in PBOC-designated interest-bearing assets, foreign exchange and RMB assets deposited separately from each other; minimum 8% ratio of RMB working capital plus RMB reserves to RMB risk assets</td>
<td>Minimum 8% capital adequacy ratio</td>
</tr>
<tr>
<td>Customer Base</td>
<td>May provide services only to foreign individuals and foreign enterprises upon accession (since December 11, 2001)</td>
<td>May provide services to Chinese enterprises by December 11, 2003</td>
</tr>
<tr>
<td>Geographic Scope</td>
<td>Shanghai, Shenzhen, Tianjin, and Dalian upon accession (since December 11, 2001)</td>
<td>Guangzhou, Zhuhai, Qingdao, Nanjing, and Wuhan (since December 11, 2002)</td>
</tr>
<tr>
<td>Qualifications to Engage in RMB Business</td>
<td>Three years PRC business operating experience</td>
<td>Two consecutive years of profits</td>
</tr>
</tbody>
</table>

NOTES: WFOE=wholly foreign-owned enterprise; EJV=equity joint venture; PBOC=People’s Bank of China; NA=not applicable
SOURCES: Nicholas C. Howson and Lester Ross
in, and participation in management of, the institution. Valuation is made even more complex because of differences that arise from the specific transaction contemplated (buyout of a promoter or government shareholder, or investment of new money into a future business) and the artificially constrained market for such transactions—which causes interested foreign banks and private equity investors to chase a small number of deals, possibly at higher prices than might be justified.

These considerations are of course merely financial and structural and ignore the important political concerns involved, from the desire to reward state shareholders “exiting” a small bank at a high value to official nervousness about ceding any kind of control over the target institution to foreign investors. And, in China’s relatively new capital markets, investment pricing may give rise to another kind of turbulence—from Chinese public shareholders comparing public issue or market prices. Citigroup and Shanghai Pudong Development Bank (SPDB) were the target of some significant grumbling from shareholders on the Shanghai Stock Exchange and the dynamic Chinese financial press, who were presented with an issue price of ¥8.45 ($1.02) for A shares of SPDB immediately after SPDB and certain SPDB shareholders had agreed to issue or sell shares in a private transaction to Citigroup at only ¥3.32 ($0.40) per share. One would expect Citigroup to use the same formula for calculating a discounted price, reportedly 1.45 times SPDB’s net asset value during the preceding year, if it exercises an option to increase its equity investment to a maximum of 24.9 percent in coming years. Although the lack of liquidity in the Citigroup shareholdings (as “unlisted foreign capital shares”) and other aspects might justify such a discount, such awkward facts can bring unwanted attention to the acquirer and affect the market for an issuer’s stock and possibly its ability to raise capital from the public.

Governance, minority rights, and investment in A-shares

It seems obvious that minority investment in any Chinese corporate vehicle may give rise to difficulties for a minority investor, foreign or Chinese. That is because China’s corporate law, even for companies that list some shares publicly, is somewhat adverse to the protection or exercise of minority rights, whether affirmative participation rights or even veto power over significant asset quality and solvency, if only to establish fair pricing.

Due Diligence

As in any acquisition, due diligence, or the full examination of the target asset, is critical in any proposed bank acquisition. A minority or passive investment by foreign investors in China’s smaller banks and financial institutions gives rise to special issues, which include:

- **Other shareholders** At present, most shareholders in China’s banks are state or local government actors which, even after the acquisition, will likely maintain almost absolute control over the bank. Investors must understand the actual intentions of these shareholders, the ways in which they might prioritize non-shareholder value-related interests, their experience acting alongside foreign investors and institutions, and their real interest in sitting alongside a foreign banking institution or private equity investor that is not a multilateral institution.

- **Asset quality: Nonperforming loans (NPLs) and reserves** With the establishment of financial asset management companies in 1999, China acknowledged significant problems with respect to asset quality in China’s major commercial banks. Some observers hoped that certain of the smaller and so-called “private” banks—all established relatively recently, and many with public listings and disclosure obligations—had not been forced into making the same kinds of bad loans, or at least not in the same high proportion as the largest state-owned banks. But as shareholders of many smaller banks are often local-level state entities, and China’s credit analysis and credit systems have a short history, this hope has not been borne out.

- **Corporate governance** It seems obvious that minority investment in any Chinese corporate vehicle may give rise to difficulties for a minority investor, foreign or Chinese. That is because China’s corporate law, even for companies that list some shares publicly, is somewhat adverse to the protection or exercise of minority rights, whether affirmative participation rights or even veto power over significant asset quality and solvency, if only to establish fair pricing.

- **Organizational and subsidiary arrangements** The largest state-owned banks have grown based on a branch network essentially donated to them upon the breakup of the People’s Bank of China’s former commercial branch network and via the establishment of legal person subsidiaries and divisions. The picture at certain smaller Chinese banks, especially when they have sought to expand outside of their home jurisdiction, is less clear. The unified legal-person status of commercial banks was not fixed in law until 1995 and is still imperfectly implemented. In some cases, bank branches are themselves joint ventures with, or at least in cooperation with, other local actors. For instance, a Shenzhen bank might have Beijing branches that are established, or invested in, by local Beijing institutions. An adequate due diligence investigation requires that any acquirer of a minority interest in a bank operation understand these anomalous relationships, any proposal that they continue, or any suggestion that these other participants be brought to the parent level with resulting dilution to existing (and new) shareholders.

—Nicholas C. Howson and Lester Ross
issues. For instance, China’s Company Law requires two-thirds approval for so-called “special resolutions” at Chinese CLSs, effectively stripping away the veto power even of holders of 33 percent of equity. Nor does Chinese corporate law permit such established mechanisms as different classes of shares or preferred share capital.

Aside from the deficiencies of China’s corporate law, the unique capital structure of PRC corporate establishments, in particular financial institutions, has an impact; the other shareholders are often state-owned or -controlled (usually local-level agencies), approaching governance and operations from a unified standpoint. Acquirers should not ignore a minority shareholder’s difficulty in truly having a voice against such entrenched interests and their directly appointed management. The result may be a truly “passive” investment for the minority holder (absent a special arrangement, such as the relatively unfettered contractual management right that was to be bestowed on Newbridge as part of its SDB acquisition). The problem becomes only more salient if the target already has, or succeeds in completing, an A- or B-share listing. In 1997, the China Securities Regulatory Commission (CSRC) laid out a rigid template form of articles of association for A- or B-share issuers, which are disadvantageous to minority (private) shareholders. CSRC’s insistence on these forms of articles of association, and pronounced dislike for shareholders’ agreements (or management agreements) for listed companies, are not good news for minority shareholders in PRC banks.

**Liquidity**

Foreign investors in PRC banks do not hold A or B shares, but instead “unlisted foreign capital shares.” Because these shares are unlisted, they are not liquid. Of course, liquidity is a far greater concern for pure private equity investors, who will be interested in some form of capital appreciation, than for foreign commercial banks, which are more likely to be content to enter the PRC banking sector as long-term market participants. Accordingly, foreign acquirers entering the banking sector as equity participants must be aware of the significant restrictions on subsequent transfer or sale.

Without a clear legal basis for minority investment in PRC banking institutions, it is unclear what approvals are needed to dispose of an equity interest in a PRC bank, either by private sale to other foreign or Chinese investors or by conversion of the equity into listed shares on a public market. It seems certain that CBRC will impose strict examination and approval requirements on any kind of attempted disposition of shares, and that the Chinese foreign exchange control authorities will hinder the ability of potential PRC purchasers to convert RMB into foreign currency to make such purchases. In the wider world of foreign investment in Chinese CLSs and disposition of holdings, foreign investors may be prohibited from selling such shares for a period of three years and must overcome significant approval hurdles before effecting a trade sale. Any proposed exit into the public markets is almost a non-starter, although in the last couple of years MOFTEC and CSRC have cooperated to allow the conversion of unlisted foreign capital shareholdings into B shares—an unappetizing prospect given the moribund B-share markets. Foreign investors hope that such new mechanisms will allow foreign investors to gain sponsored listings of their private shareholdings in Chinese CLSs on the Hong Kong and foreign markets, and eventually the far more dynamic A-share markets. At this point, however, real liquidity for the private holdings of foreign investors in Chinese banks is a long way off.

**First steps**

As the growth of China’s economy continues, as the burgeoning financial sector continues to be underserved, and as both foreign strategic investors and private equity value investors seek to participate in China’s financial services industry, minority equity investments in China’s small and medium-sized commercial banking institutions will only accelerate. Foreign financial players will also continue to seek footholds in financial services sectors other than commercial banking—corporate finance, insurance, asset management, and eventually domestic investment banking.

Given the entry barriers in each of these sectors, and depending on their corporate strategy, many large foreign groups may enter the retail banking area first, as minority equity participants, with some kind of added contractual (whether management or co-branding) mechanism. In time, and with increasing liberalization, such foreign groups may benefit from integration among PRC financial service companies, whether through mergers, broadened scopes of business, or even cross-holdings. At that time, minority participation in small-scale commercial banking operations with some element of control may prove to have been a good first step toward a full-service operation.