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The Determinants of Chinese Banks'

Foreign Direct Investment in EU

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1. Introduction

In recent years, an increasing outward orientation has become one important characteristic of the growing Chinese economy. Chinese foreign trade has kept growing consistently and the bilateral trade between China and EU has grown rapidly. To quote Romano Prodi - President of the European Commission:¹ “Good news about the Chinese economy is of course good news for Europe...It is good for European exporters, who like their American and Japanese counterparts are eager to get a piece of the action, and who from all accounts, seem to be doing rather well. The EU is currently China's third biggest trade partner ... EU exports to China rose in 2003 by around 40% compared with 2002. The EU now provides China with 16% of its total imports and we are gaining market share. European investment in China has also increased dramatically, and actual investment by European companies is now only marginally lower than that of US companies.” Meanwhile China’s export to EU reached 72,155 million US Dollars in 2003, increasing by 49.7% compared with 2002.²

1.1 Research questions and methodology

¹ Prodi, R. Presentation to the China-Europe International Business School on April 15 2004
http://www.delchn.cec.eu.int/en/whatsnew/prodi_CEIBS150404.htm Accessed on April 29 2004

² Ministry of Commerce of People’s Republic of China website,
http://ozs.mofcom.gov.cn/article/200402/20040200176082_1.xml Accessed on April 29 2004

Thanks to the rapid growth of the Sino-EU trade, the Chinese banks are enjoying more opportunities to develop their overseas business in EU. Now the overseas business in EU is becoming an important part in the entire operations of Chinese banking. However it is somewhat surprising that little concern have being expressed about the growing presence of Chinese banks in EU, nor studies examining what factors affect the Chinese banks FDI in EU.

This paper seeks to explain the determinants of Chinese banks foreign direct investment³ (FDI) in EU. In this paper, factors affecting the Chinese banks' FDI in EU have been investigated based on a full-scale survey against the Chinese banks having their branches and subsidiaries in EU.

Theories and approaches suggested so far about globalization of the banking sector mainly relate banks' international growth to the theory of the multinational enterprises (MNEs)⁴. Accordingly, this paper relies on the eclectic paradigm, which analyses the foreign direct investment decision to be a combination of ownership, internalization and location advantages. Empirical evidence is provided based on a full-scale survey against the Chinese banks that have their branches and subsidiaries in EU and on the data obtain from the related websites.

1.2 Multinational bank and its organization form

A multinational bank (MNB) is an international financial intermediary which owns

³ According to Oxelheim, L. and Ghauri, P., "A direct investment implies a permanent relationship between the investor and the object, and particularly the opportunity for real influence over the object's operation. Investments that do not fit the description are to be classified as portfolio investment. The aim of the foreign direct investment according to the IMF definition is to 'acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise.'...The common view/rule of the practical minimum of equity for having an effective voice in management is a 10% ownership." See Oxelheim, L. and Ghauri, P., *The race for FDI in the European Union*, (p.30) In Oxelheim, L. & Ghauri, P.N. (Eds), *European Union and the race for foreign direct investment in Europe* (p.3-34). London: Elsevier

⁴ A multinational enterprise is an enterprise which owns or controls value-adding activities in two or more countries. See Dunning.J.H. (1989), *Multinational enterprises and the growth of services: some conceptual and theoretical issues. The Service Industries Journal*, 1.

and controls branches and affiliates in more than one country.⁵ The following organizational forms are generally available to the bank: representative office, branch and subsidiary.

The representative office is the cheapest overseas banking organizational form which constitutes the lowest level of commitment.⁶ It is designed to promote the bank's name, making contacts in the foreign market and supplying information of all kinds to Head Office.

A branch is an office which is legally under the control of the head office of the bank, and the branch is 'protected' by the total capital of the entire bank.⁷ Foreign branches could actively participate in the host country's banking system therefore constitute a higher level of commitment with the market.⁸

Foreign subsidiaries are incorporated to the host banking system. They maintain separate legal entities and are subject to the legislation of the host country.⁹

1.3 Delimitation

Due to the fact that the representative office is generally prohibited from active banking activities in the host country, the paper will focus on the other two organizational forms of the bank: branch and subsidiary.

⁵ Jones, G. (1992). The legacy of the past: British multinational banking strategies since the nineteenth century. In P.Buckley, & M.Casson (Eds), *Multinational enterprises in the world economy*. Aldershot: Edward Elgar.

⁶ Heinkel. R.L. & Levi. M.D. (1992). The structure of international banking. *Journal of International Money and Finance*, 11, 251-272

⁷ Burgers.I.J.J. (1991) Taxation and supervision of branches of international banks, a comparative study of banks and other enterprises. IBFD Publications. P.36

⁸ Heinkel. R.L. & Levi. M.D. (1992).

⁹ Burgers.I.J.J. (1991)

The study of legislation framework of EU on banking would focus on relative legislation on third country's commercial banking activities. The legislation on investment banking and other banking business area remains untouched.

The sources of data have limitations that impact the scope and sophistication of the analysis. Detailed financial information for the Chinese state-owned banks was not required by government regulations to be disclosed to the public until May 21, 2002 a new set of rules for standardized information disclosure was introduced by China's central bank the People's Bank of China aimed to improve Chinese commercial banks' transparency.¹⁰ The data of their overseas branches is even harder to obtain since the branch is not an independent legal entity.

1.4 Structure of the paper

The paper is organized as follows. Section 2 reviews the FDI theory on banking. Some previous empirical studies on the determinants of FDI in banking have also been discussed. Based on the arguments and evidence of previous theories and studies, the main determinants of FDI in banking have been synthesized. The third section studies the EU banking legislation, which set up the legal framework and preconditions of third country banks' market access and operation in EU. Section 4 gives a brief introduction of the Chinese banking industry and its regulation on banking activities, while the fifth section analyses the determinants of Chinese banks' FDI in EU based on the results of the full-scale survey against the Chinese banks having their branches and subsidiaries in EU. Some summarizing remarks conclude the paper.

¹⁰ People's Bank of China website <http://www.pbc.gov.cn/jinrongfagui/> (accessed April 26, 2004)

2. A Review of Literature on Determinants of FDI in Banking

The recent decade has witnessed unprecedented opportunities and challenges to the multinational banking sector, during which period the products offered, the technology and the regulatory framework have undergone significant changes both in developed and developing countries.¹¹

Nevertheless, multinational banking has not received research concern as much as such a phenomenon would deserve, and serious lacunae still exist.¹² However theories have been well developed upon the motives for FDI by MNEs. As banks are enterprises, an appropriate point of entry to the question of the determinants of FDI in banking sector would be the theories that have been developed to explain the FDI by MNEs.

In this chapter, first, some conceptual issues regarding the MNEs and MNBs will be defined. Then prevalent theories on FDI and MNEs will be reviewed, and their applications to multinational banking as well as previous empirical studies will be discussed.

¹¹ See Miller, S.R., & Parhke, A. (1998) Patterns in the expansion of US bank's foreign operations. *Journal of International Business Studies*, 9, 359-390. Also see Dacosta, M.& Foo, W. (2002). China's financial system: two decades of gradual reforms. *Managerial Finance*, Vol.28, Number 10

¹² Dunning, J.H. (1993). The globalization of service activities. In J.H. Dunning (Ed.), *The globalization of business*. (pp242-284) London: Routledge.

2.1 The multinational enterprise and multinational bank

A multinational enterprise has been defined by Dunning as ‘...an enterprise that owns or controls value-adding activities in two or more countries.’¹³ This definition for MNE implies that physical presence is not required for multinational activity to occur. Developments in the institutional and technological features of multinational banking have made the cross-border service possible. For example, Participated in syndicated loans can result in loans being made to foreign enterprises, denominated in foreign currencies, without the lender leaving its country of original incorporation. This circumstance of MNB is consistent with the broader definition of MNE.

However, regulations governing areas of the financial services sector are country-specific. It is still almost impracticable to take any cross-border activity without (physical) establishment. Even in EU, where significant efforts have been made to create a single market, retail financial services are nearly only provided by banks located in the respective countries. Many jurisdictions require a bank must have a physical presence before it can enter the market for retail banking service.¹⁴ In this respect, Jones’s definition of multinational bank as “an international financial intermediary which owns and controls branches and affiliates in more than one country”¹⁵ seems practical.

MNBs undertake their own particular activities which are distinct, but interrelated, not only among themselves but also linked to other sectors including trade, goods, etc.¹⁶ MNBs could be considered as a subset of MNEs. In the following part, the theory on

¹³ Dunning, J.H. (1989), Multinational enterprises and the growth of services: some conceptual and theoretical issues. *The Service Industries Journal*, 1.

¹⁴ Molyneux, P. (2004) The FDI race in European banking. In: Oxelheim, L. & Ghauri, P.N. (Eds), *European Union and the race for foreign direct investment in Europe* (p.460-483). London: Elsevier

¹⁵ Jones, G. (1992).

¹⁶ Dunning, J.H. (1993)

FDI of MNEs will be reviewed to explain why MNEs offer their services via a direct presence rather than through other mode. Current empirical studies of MNEs' FDI activities will also be examined to show the determinants of the FDI for MNEs.

2.2 Prevalent theories on FDI

2.2.1 Hymer and Kindleberger theory

Hymer¹⁷ considers that the special feature of FDI is the fact that it gives the investor control, thus making the investment safer. FDI should be seen in the context of the search for control by oligopolistic enterprises. Moreover, he indicates the importance of the so-called 'advantages' theory of horizontal investments¹⁸ by MNEs and distinctly argues that a firm would go abroad rather than license or sell its technology when the special advantages it possessed require its own control.

Hymer and Kindleberger¹⁹ try to determine the advantages of foreign-owned firm have over the domestic firms. They assume that direct involvement abroad is costly and risky due to (i) costs of communication and of acquisition of information in general; these costs are linked to the different cultural, linguistic, legal, economic and political background in which the firm will have to operate in the host country; (ii) costs due to less favorable treatment given by host countries' governments; and (iii) costs due to exchange rate risks. To overcome these costs, the foreign firm must possess some counterbalancing advantages. These are the so-called firm-specific

¹⁷ Hymer, S.H. (1971) The multinational corporation and the law of uneven development. In Bhagwati, J.W. (ed.), *Economics and World Order*. London: Macmillan, 113-140. Reproduced in Radice, H. (ed) (1975), *International Firms and Modern Imperialism*. Harmondsworth: Penguin, 113-135.

¹⁸ Through horizontal investment the MNE extends its operations abroad by producing the same product in new countries.

¹⁹ Kindleberger, C.P. (1969) *American Business Abroad: Six Lectures on Direct Investment*. New Haven, CT: Yale University Press.

advantages, which may include ownership of brand name, possession of marketing skills, patents, technology, lower cost finance, managerial skills, economies of scale and economies of vertical integration.²⁰ These advantages are not sold or licensed due to imperfections in the patents markets and other market failures. The production is conducted overseas to (i) reduce the cost of transportation, and (ii) adapt the product to local conditions.

However, as costs of acquisition are ignored, Hymer and Kindleberger theory does not explain why one form of investment is preferred over another.

2.2.2 Product life cycle theory

Product life cycle theory from Vernon²¹ purported to explain why particular competitive advantages possessed by MNEs or potential MNEs originated in one country rather than another, and how these advantages tended to be exploited first by domestic production for the home market, then by exports and finally by FDI. The theory assumed that communication costs within the firm, and between the firm and the market, are significant and will increase with distance.

In the early stage of development of a product, firms placed factories close to markets because of the need for frequent feedback from market to plant, i.e. the so-called 'communication costs'. Technical innovation will occur in advanced markets and so production stays in the advanced market. Innovation will occur close to the consumers, as a respond to the consumers' needs. In this phase flexibility and responsiveness are treated to have more importance than lower cost inputs and can be achieved by

²⁰ Vertical integration implies that the firm becomes directly involved in other stages of the production process (whether backward or forward stages or both) connected with the product it already produces.

²¹ Vernon, R. (1966) International investment and international trade in the product cycle. *Quarterly Journal of Economics*, 80, 190-207

choosing a near location to consumers. During the second stage, firms manage to entry generated by economies of scale and marketing and research advantages. Inside this market, the participants conduct vigorous competition, and potentially a price war, until market shares are stabilized. At this stage overseas markets will be serviced by exporting. During the final stage, economies of scale is no longer a barrier to entry, and after tries to create new barriers to entry by product differentiation, the market becomes contestable. The location choice will then be decided by the cost of inputs.²² It is during this phase that production will move offshore and the firm will develop into a multinational enterprise, using FDI.

According to Dunning²³, the product-life cycle theory is useful in explaining some of the reasons for the early foreign involvement of some service MNEs in such areas as commercial banking, insurance etc. However, the theory does not explain investment in industries where product innovation is ongoing, or the product is non-standardized. Therefore, the theory is not helpful in explaining why some MNEs are, themselves, diversified.

2.2.3 Eclectic theory

Dunning's eclectic approach²⁴, consists of an attempt to analyze the why and where decisions of MNE's FDI activity in terms of ownership, location and internalization advantages. Ownership advantages are those that are specific to a particular enterprise and that enable it to take advantage of investment opportunities abroad. Location advantages are those advantages specific to a country that are likely to make it

²² Vernon develops the link between location of production, multinationality and oligopolistic structures in his 1974 paper. See Vernon (1974) The location of economic activity. In Dunning, J.H. (ed.), *Economic Analysis and the Multinational Enterprise*. London: Allen and Unwin, 89-113.

²³ Dunning, J.H. (1993).

²⁴ Dunning, J.H. (1977). Trade location of economic activity and the multinational enterprise: A search for an eclectic approach. In: B.Ohlin, P.O. Hasselborn, & P.M. Wikman (Eds), *The international allocation of economic activity* (pp.395-418). London: Macmillan.

attractive for foreign investors. Internalization advantages are all those benefits that derive from internal markets and that allow firms to bypass external markets and the costs associated with them. According to Dunning's theory, a firm is theoretically unlikely to invest directly in a foreign country if any one of the OLI advantages is not intact.

So does Dunning's dynamic approach,²⁵ in which ownership, location and internalization advantages interact with each other. Dunning identifies three conditions for FDI to take place:

1. The firm concerned must possess 'net ownership advantages vis-à-vis firms of other nationalities in serving particular markets'.²⁶
2. The firm must obtain benefits from internalizing the use of resources in which it has an advantage rather than selling them on external markets, e.g. via licensing.
3. The country where the FDI takes place must have special location advantages to be coordinated with those deriving from ownership and internalization.

Location advantages and countries' differences may create incentives to internalize; at the same time internalization creates further ownership advantages.

In his 1989²⁷ and 1993²⁸ articles, Dunning further developed and modified the paradigm to explain the activity of MNC in the services sector. He gives 'some illustrations of the kind of OLI variables likely to determine the extent and form of international production' in the commercial banking/financial services sector.²⁹

A multinational bank entering foreign markets must have a unique competitive advantage over host country rivals (ownership advantage). Those advantages may include access to transnational clients and international capital and financial markets, professional expertise, economies of size and scope, intrinsic value of reserve

²⁵ Dunning, J.H. (1980). Explaining changing patterns of international production: in defense of the eclectic theory. *Oxford Bulletin of Economics and Statistics*, 41 (4), pp269-295

²⁶ Ibid. p275

²⁷ Dunning, J.H. (1989). Multinational enterprises and the growth of services: some conceptual and theoretical issues. *The Service Industries Journal*, 1.

²⁸ Dunning, J.H. (1993).

²⁹ Ibid. pp271-277

currencies, and control over trans-border data and communication networks.

Those advantages should be most efficiently exploited in foreign markets within the multinational bank rather than via arm's length market exchange (internalization advantage). The internalization advantages may stem from economies of scope and coordinating capital flows, quality control, and international arbitraging.

The chosen foreign market should allow the returns from the advantage to be maximized (location advantage). As Dunning summarized, the major factors of location advantage (country-specific endowments) in financial services industry may be embodied in government regulations, high-value activities often centralized, lower costs of foreign operations, among other factors.

However, some researchers consider that it is incorrect to assume that a MNE needs an ownership advantage relative to the domestic incumbents. Casson³⁰ considered 'combination of internalization and location advantage is itself sufficient to explain multinational activities' and could overcome the Hymer-Kindleberger type costs without the need for a firm to own any other advantage. As discussed by Casson, the application of Eclectic theory's concept of ownership provides explanatory power regarding the growth of the MNE. However, the concept of ownership is one more correctly applied to the explanation of multinational performance post entry, rather than to the demonstration of necessity pre entry.

2.3 Economic theories on multinational banking

The economic theories suggested so far about FDI in banking sector basically relate banks' international growth to the theory of the multinational enterprise. The literature sometimes supported by analysis of descriptive statistics, which apply economic

³⁰ Casson, M. (1987) General theories of the multinational enterprise: A critical examination. In: Casson, M. *The Firm and the Market*. Oxford: Blackwell.pp31-49

concepts of FDI and international trade to multinational banking. The focus of much of these literatures is the importance of the maintenance of established customer relationships as a factor in a MNB's FDI decision.

Gray and Gray³¹ proposed that all banks have a firm-specific advantage in information capital and if an existing customer is lost to another bank, then the ensuing information transfer reduces the former bank's advantage. So a multinational bank chooses to locate in countries where its established customers operate in order to minimize the loss. The authors also identified regulatory guidelines in the home country as a motivation for establishing foreign banking operations. MNBs are attracted to largely unregulated supranational markets, where unrestricted banks asset, liability, and foreign exchange management permit higher rates of return on equity than domestic regulation allows.

Yannopoulos³² argued that internalization in multinational banking is largely sourced from information, which has a crucial role in banking. The bank-client relationship consists primarily of flows of information and information inputs are difficult to obtain at arms length because of problems of appropriation and protection of proprietary of interests. Because of the 'orientation contact' nature of the information services provided to the corporate customers, it is important that the multinational bank is located in countries close to the information source. Location advantages, according to Yannopoulos, consist mainly of follow-the-client, country-specific regulations, and entry restrictions.

Cho³³ provided more specific examples of OLI advantages. Ownership advantages are categorized to include access to skilled personnel and managerial resources, favorable financial sources, widespread and efficient banking networks, knowledge

³¹ Gray, H. Peter, & Jean M. Gray. (1981). The multinational bank: a financial MNC? *Journal of Banking and Finance*, 5, March: 33-63

³² Yannopoulos, G.N. (1983). The growth of transnational banking. In M. Casson (Ed.), *The Growth of International Business*, (pp.236-257) London: George Allen and Unwin.

³³ Cho, K. R. (1986). Determinants of international banks. *Management International Review*, 26, 10-23.

and experience in multinational operations, expertise in servicing a particular customer type, established creditworthiness, differentiation of banking products, and prestige. Location advantages consist of five types: regulatory frameworks, effective interest rate differences, different economic situations, nationality of banks, and socioeconomic differences. Internalization advantages are divided as: availability and cost of fund transfers within the multinational banks, efficient customer contacts, transfer pricing manipulation, improved networks for information gathering, and potentially reduced earning variability.

2.4 Empirical studies on determinants of multinational banking

Several empirical studies of MNBs have been conducted to determine how well the evolving strategic and economic theories withstand more rigorous testing. Because of the difficulty of modeling expectations prior to choosing a location, these empirical studies have investigated the determinants of a MNB's level of involvement after entering a host country location.

The US experience has received most of the empirical study concerns. The researchers formulate econometric models of MNB activities and utilize regression analysis of data aggregated across foreign banks to test the validity of their models.

Taking the United States as a host country, using the state-level data, Goldberg and Saunders³⁴ examine the determinants of the growth of foreign banks assets in the US. Goldberg and Grosse³⁵ further investigate the determinants of the spatial distribution

³⁴ Goldberg, L.G. & Saunders, A (1981). The determinants of foreign bank activity in the United States. *Journal of Banking and Finance*, 5, 17-32

³⁵ Goldberg, L.G. & Grosse, R. (1994) Location choice of foreign banks in the United States. *Journal of Economics and Business*, 46, 367-379.

of foreign financial activities in the US. They find that the total values of trade flows are positively related to the level of foreign banking presence in the US. They also show that the local banking opportunity is an important determinant of foreign bank location within the US.

Some studies are based on the different nationalities of the banks in the US. Hultman and McGee³⁶ and Grosse and Goldberg³⁷ study the determinants of foreign banking activities in the US by the country of origin. The result shows that the foreign investment in the US, foreign trade with the US, and the size of the banking sector in the foreign country are important influential factors for that country's bank presence in the US.

There are also several studies that deal with the determinants of US banks expansion in foreign countries. Goldberg and Saunders³⁸ examine the factors affecting the expansion of US banks into UK. The result shows that the growth of US banks in UK is significantly related to the increase of US trade with UK.

Sabi³⁹ examines the determinants of US banks' entering into less developed countries, concluding that the US FDI is significantly conducive to the growth of US banking activities in that country. Host country market size also has positive effect.

Nigh et al.⁴⁰ investigate the determinants of US banks' entering into 30 countries including both developed and less developed countries. According to their result, the US FDI has significant influence on the US banking expansion in that country. They

³⁶ Hultman, C.W., & McGee, L.R. (1989) Factors affecting the foreign bank presence in the US. *Journal of Banking and Finance*, 13, 383-396

³⁷ Grosse, R., & Goldberg, L.G. (1991). Foreign bank activity in the United States: An analysis by country of origin. *Journal of Banking and Finance*, 15, 1093-1112

³⁸ Goldberg, L.G., & Saunders, A., (1980). The causes of US bank expansion overseas: The case of Great Britain. *Journal of Money, Credit, and Banking*, 12, 630-643

³⁹ Sabi, M., (1988). An application of the theory of foreign direct investment to multinational banking in LDCs. *Journal of international Business Studies*, 19, 433-447

⁴⁰ Nigh, D., Cho, K.R., & Krishnan, S., (1986) The role of location-related factors in US banking involvement abroad: An empirical examination. *Journal of International Business Studies*, 17, 59-72.

also conclude that local market opportunity has little effect on the US banks' geographical choice. This conclusion is quite different from those of other studies about non-US banks' location choice within the US (e.g., Goldberg and Grosse 1994).

Goldberg and Johnson⁴¹ examine the determinants of US banks' expansion into 22 foreign countries. They use per capita GDP of foreign countries as a measure of domestic banking opportunity. The result shows that per capita GDP, FDI by US companies and US trade are main determinants regarding the location choice of US banks. However their results about the effect of domestic banking opportunity are contrary to the conclusion of Nigh et al.

As regards the non-US experience, Ursacki and Vertinsky⁴² examine the determinants of the timing decision and the scale of the commitment of foreign banks to enter the Japanese and Korean markets. They find that size and the existing level of geographical diversification of the foreign bank are the most important factors. Home market entry regulation and development of the host country's financial center are also influential factors.

Fisher and Molyneux⁴³, replicate Grosse and Goldberg⁴⁴'s methodology, investigate the determinants of foreign bank activity in London by the country of origin of the investing banks. They find that the size of the banking sector in the foreign country, bilateral trade with UK, FDI (from European and non-US or Japanese sources) have positive effect on the foreign country's bank presence in London.

Hondroyiannis and Papapetrou⁴⁵ examine the growth of assets of foreign banks and

⁴¹ Goldberg, L.G., & Johnson, D., (1990). The determinants of US banking activity abroad. *Journal of International Money and Finance*, 9, 123-137.

⁴² Ursacki, T., & Vertinsky, I. (1992) Choice of entry timing and scale by foreign banks in Japan and Korea. *Journal fo Banking and Finance*, 16, 405-421

⁴³ Fisher, A., & Molyneux, P. (1996) A note on the determinants of foreign bank activity in London between 1980 and 1989. *Applied Financial Economics*, 6, 271-277.

⁴⁴ Grosse, R., & Goldberg, L.G (1991).

⁴⁵ Hondroyiannis, G., & Papapetrou, E. (1996) International banking activity in Greece: The recent experience. *Journal of Economics and Business*, 48, 207-215.

the number of branches in Greece by country of origin. The results show that foreign trade with Greece, country's creditworthiness, the size of the banking sector in the foreign country and the geographic distance of the foreign country from Greece are the most influential factors for foreign bank presence in Greece.

Yamori⁴⁶ studies the worldwide location choice of Japanese banks in other countries, concluding that FDI of the Japanese manufacturing industry is of most importance for the location choice of the Japanese banks. The local banking opportunity in the host country has positive effect as well.

2.5 Synthesis of the determinants of FDI in banking

Synthesis of the arguments presented in the economic literatures with evidence of authors from the empirical literature suggests that the following factors shape the OLI advantages of MNB's FDI activity:

Ownership advantages:

1. Large bank size.⁴⁷
2. Geographical diversification of banking networks.⁴⁸
3. Large domestic capital and deposit base.⁴⁹
4. Extensive customer base.⁵⁰

Internalization advantages:

Information capital (to protect established bank-customer relationship and to follow

⁴⁶ Yamori, N. (1998) A note on the location choice of multinational banks: The case of Japanese financial institutions. *Journal of Banking and Finance*, 22,109-120

⁴⁷ Dunning 1989,1993, Hultman & McGee 1989, Grosse & Goldberg 1991, Fisher & Molyneux 1996, Hondroyiannis & Papapetrou 1996

⁴⁸ Dunning 1989,1993, Cho 1986, Ursacki & Vertinsky 1992

⁴⁹ Yannopoulos, 1983, Cho 1986

⁵⁰ Gray & Gray 1981, Yannopoulos 1983

the customer).⁵¹ As a proxy variable to measure the ‘follow the customer’ motive, FDI from the home country to the host country has been concluded to be the most important affecting factor.⁵² The volumes of trade between the host and home country are also reported to have a positive influence on MNB level of involvement abroad⁵³

Location advantages:

1. Local banking opportunity in the host country.⁵⁴ (Since there are different empirical test results about this factor, the effect of local banking opportunity needs further study)
2. The presence of an international financial center in the host country.⁵⁵
3. The extent of regulation of banking activities in the host country relative to the multinational bank’s home country.⁵⁶

Although there are various theories and empirical studies, the literature suggests there are some certain determinants of FDI in banking. A bank must possess some ownership advantages, which enable it to profit from extending its operations into foreign markets. These advantages are most efficiently exploited in foreign markets within the bank than via arm’s length market exchange (internalization advantage). And the chosen foreign market allows the returns from the advantage to be maximized (location advantage). The previous studies make the synthesis of the major OLI advantages of FDI in banking possible. However, to what extent these findings hold true for Chinese banks’ FDI in EU remains an unexplored area. In the following chapters, the legal framework determining foreign banks’ market access into EU will be examined, some background knowledge about Chinese banking industry and its development will be introduced, and then we examine whether the results of previous studies about MNBs hold true for the Chinese banks’ FDI in EU.

⁵¹ Yannopoulos 1983

⁵² Hultman & McGee 1989, Grosse & Goldberg 1991, Sabi 1988, Goldberg & Johnson 1990, Yamori 1998

⁵³ Goldberg & Saunders 1980, 1981, Goldberg & Grosse 1994, Hultman & McGee 1989, Grosse & Goldberg 1991, Goldberg & Johnson 1990, Fisher & Molyneux 1996, Hondroyiannis & Papapetrou 1996

⁵⁴ Sabi 1988, Goldberg & Saunders 1980, Goldberg & Grosse 1994, Goldberg & Johnson 1990.

⁵⁵ Ursacki & Vertinsky 1992

⁵⁶ Gray & Gray 1981, Yannopoulos 1983, Ursacki & Vertinsky 1992

3. The EU Legislation on third country banks

The purpose of this part is to outline the principal measures adopted in connection with the regulation of the activities of banking within the EU, especially the regulation regarding third countries, i.e. regulation which set up the legal framework of third country banks' market access and operation in EU.

3.1 Reciprocity principle

The current EU legislation on banking is the Council Directive 2000/12/EC (hereinafter called the 2000 Directive). The 2000 Directive is a single text codified and combined the previous Council Directives relating to the business of credit institutions.⁵⁷ It provides the general requirement and minimum standard at EU level concerning the taking up and pursuit of the business of credit institutions, where the principles set out in the previous Directives of mutual recognition, single banking license, home country control and supervision, the single requirement for endowment capital and the minimum harmonization of essential prudential rules at the EU level remain unchanged.

⁵⁷ The repealed Directives include Directive 73/183/EEC on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions, 77/780/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, 89/299/EEC on the own funds of credit institutions, 89/646/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, 89/647/EEC on a solvency ratio for credit institutions, 92/30/EEC on the supervision of credit institutions on a consolidated basis, 92/121/EEC on the monitoring and control of large exposures of credit institutions. (Article 67 of Directive 2000/12/EC)

Special provisions dealing with the problem of third country banks may be found in Art.23 of the 2000 Directive (formerly in Art.8 and 9 of the Directive 89/646/EEC). Generally speaking, the 2000 Directive allows for reciprocal access to the EU market for banks from non-EU countries.

With the adoption of the single banking license⁵⁸, the national reciprocity requirements became ineffective and the reciprocity principle would be evaluated on a Community basis. This should be read in light of “Community intends to keep its financial markets open to the rest of the world, to improve the liberalization of the global financial markets in other third countries”⁵⁹.

The reciprocity provisions are embodied in Article 23 of the 2000 Directive:

- . National authorities of member states must give notice to the Commission of their authorization of a subsidiary of a third-country undertaking or of the acquisition of a holding in a Community credit institution by such an undertaking.
- . Member states should report any general difficulties encountered by their credit institutions in establishing or conducting operations in a third country, and the Commission is required to draw up periodic reports on the treatment accorded to Community credit institutions in third countries.
- . Where it appears to the Commission that a third country is not granting Community credit institutions effective market access, comparable to that granted by the Community to credit institutions from that third country, the Commission may propose to the Council that negotiations be undertaken with the country in question to obtain comparable competitive opportunities.
- . Where neither national treatment nor effective market access is accorded to Community credit institutions in a third country, the Commission may initiate negotiations in order to remedy the situation.

⁵⁸ Art.19 of the Second Banking Directive (Directive 89/646/EEC). Now Art. 20(1)-(6) of Directive 2000/12/EC.

⁵⁹ Directive 2000/12/EC. preamble parag 20

- . Any measure taken must comply with the Community's obligations under any international agreements governing the taking up and pursuit of the business of credit institutions.

The 2000 Directive has made it clear that reciprocity rather than national treatment will serve as a criterion as to the treatment to third country undertakings. However it is submitted that this is hardly a requirement of reciprocity as such, and indeed Art.23 (7) of the 2000 Directive states that any measures taken must comply with the Community's obligations under any international agreements governing the taking up and pursuit of the business of credit institutions, which provision anticipates the outcome of the GATS negotiations.

3.2 The General Agreement on Trade in Services (GATS)

The Uruguay Round of trade negotiations has provided opportunities for many financial institutions to expand their business activities globally. It is worth mentioning that further negotiations on trade in financial services continued, after the completion of the Uruguay Round, with a new Agreement reached under the General Agreement in Trade in Services (GATS) in December 1997.⁶⁰ It is the first set of multilateral rules for international trade in services.⁶¹ Both the Community and its Member States are parties to GATS therefore they are obliged to comply with the rules and obligations contained in the various GATS agreements. Under the GATS, the EU is committed to allowing their markets to be opened to all foreign banks.

The GATS distinguishes between general obligations and a framework for specific commitments. One of the most important general obligations is transparency. This

⁶⁰ Moshirian, F. (2004) Financial services: global perspectives. *Journal of Banking and Finance*, 28, 269-276

⁶¹ Gugler, P. (2004). The WTO and the race for inward FDI in the European Union. In: Oxelheim, L. & Ghauri, P.N. (Eds), *European Union and the race for foreign direct investment in Europe* (p.59-100). London: Elsevier

obligation requires all members to publish ‘all relevant measures of general application’ that influence trade in financial or other services. Another basic general principle is the Most-Favored-Nations (MFN) principle designed to stop any member from discriminating against other members. However, the GATS has a special list showing where (in which areas) countries are temporarily not applying the ‘most-favored-nation’ principle of non-discrimination.⁶²

As for specific commitments, the GATS provides for Market access (Article XVI) and national treatment (Article XVII). With regard to market access, Art. XVI(1) provides that each Member shall accord services and service suppliers of any other Member treatment no less favorable than that provided for under the terms, limitations, and conditions agreed and specified in its schedule. Limitations set out in the Schedule of Specific Commitments of the EC and its Member States annexed to Council Decision 1999/61/EC⁶³ relate almost exclusively to limitations on market access imposed in individual Member States. With regard to national treatment, Art. XVII(1) provides that ‘in the sectors inscribed in its schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers’.

However, it is suggested that market access and national treatment principles are subject to national treatments of these two principles, and being incorporated into the national rules. Member countries are still allowed to apply national regulations regarding market access and national treatment for the establishment of foreign companies.⁶⁴

⁶² Ibid. pp62

⁶³ OJ 1999 L20/38 *Council Decision of 14 December 1998 concerning the conclusion on behalf of the European Community, as regards matters within its competence, of the results of the World Trade Organization negotiations on financial services.*

⁶⁴ Moshirian. F. (2004)

EU member states applied different restrictions in their specific schedules of commitments.⁶⁵ In banking services, Luxembourg and the Netherlands are still the most favorable for foreign investors since there is no restrictions for cross-border supply of services (the possibility for non-resident service providers to supply services over the border into a member's territory), no restrictions for consumption abroad (the freedom for a member's resident to purchase services inside the territory of another member), and no restrictions for 'commercial presence' (the opportunities for foreign service suppliers to establish, operate or expand a commercial presence, such as a branch, agency, or fully-owned subsidiary, in a member's territory). Except these two 'particularly attractive' countries, all other EU member states have some restrictions, although in different degrees.⁶⁶

For example, in Finland, at least half of the founders, the members of the board of directors, the supervisory board and the delegates, the managing director, and the person entitled to sign in the name of the credit institution shall have their place of residence in the European Economic Area, unless the Ministry of Finance grants an exemption.⁶⁷

In Portugal, the establishment of non-EU banks is subject to an issued authorization, on a case-by-case basis, by the Minister of Finance. The establishment has to contribute to increasing the national banking system's efficiency, or has to produce significant effects on the internationalization of the Portuguese economy.⁶⁸

In Sweden, undertakings not incorporated in Sweden may establish a commercial presence only through a branch, and in case of banks, also through a representative office.⁶⁹

⁶⁵ The current rules governing non-EU bank's market access in EU member states is "European Community and Its Member States Final Schedule of Special Commitments in Financial Services Nov 1999" GATS/SC/31/Suppl.4/Rev.1 18 November 1999 (99-5018)

⁶⁶ See GATS/SC/31/Suppl.4/Rev.1 18 November 1999 (99-5018)

⁶⁷ Ibid.

⁶⁸ Ibid.

⁶⁹ Ibid.

In commercial banking sector, generally speaking, the EU and its member states do not have very strict limitations on non-EU banks' market access, although Portugal, Greece, Austria, Sweden and Finland impose restrictive measures on non-EU bank's market access in different content and in different degree.⁷⁰

3.3 Regulation on subsidiaries of third country banks

The 2000 Directive sets out the principle that a credit institution authorized in one Member State may establish a branch or offer services in any other Member State. Subsidiaries of third country banks incorporated in any member state of the EU are legally independent entities subject to Community law and to the respective national legislation of the country of the subsidiary's incorporation. Art. 48 of the EC Treaty extend the benefit of provisions on establishment and services to "companies or firms formed in accordance with the law of a Member State and having their registered office, central administration, or principal place of business within the Community". Therefore subsidiaries of third country banks will also be treated as Community credit institutions and have the same rights and obligations as other "domestic" EU credit institutions. Once authorized by the competent authority of the country of incorporation, the subsidiary will be able to take advantage of the "single banking license" to establish branches within the Community and to provide services under the principle of mutual recognition.⁷¹ Moreover, the 2000 Directive confirms that the EC has adopted the universal banking model. The permitted activities of credit institution listed in the appendix to the 2000 Directive are very broad, covering the realities of the financial markets. Subsidiaries of third country banks could engage in universal

⁷⁰ Ibid

⁷¹ Mutual recognition had already been developed with considerable effect in the area of the Free Movement of Goods following the European Court of Justice's landmark decision in *Cassis de Dijon* in 1979. The essence of mutual recognition in banking sector is to secure that a credit institution authorized by the home state authority to have same market access in other member states.

banking business in EU as well.

a) Conditions for authorization

The competent authorities of Member States are required to verify that the following conditions have been met before authorizing new credit institutions:

- the initial capital is at least EUR 5 million,⁷²
- Two or more persons of good repute and sufficient experience to effectively direct the business of the credit institution and to perform such duties,⁷³
- credit institution should provide a program of operations detailing the types of business envisaged and the structural organization of the institution when apply for authorization,⁷⁴
- credit institution shall inform the competent authorities the identities of all persons with share holdings or voting rights of more than 10 percent in the credit institution when apply for authorization for the taking-up of the business.⁷⁵

b) Conditions for operation

The 2000 Directive requires that the following minimum conditions should be met with regard to the activities to be pursued by credit institutions established in the EU.

- . A credit institution wishing to provide cross-border services within the Community for the first time should notify the supervisory authorities of the home country and provide a list of the activities it intends to pursue.⁷⁶
- . A credit institution wishing to establish a branch in another member state must notify its supervisory authority of its intention to open a branch in a specific member state, the activities to be undertaken by the branch, the address of the branch and the

⁷² Directive 2000/12/EC. Art.5

⁷³ Ibid. Art. 6(1)

⁷⁴ Ibid. Art. 8

⁷⁵ Ibid. Art.7

⁷⁶ Ibid.Art.21 (1)

- name of the branch managers.⁷⁷
- . The host member state may require periodic reporting on the activities of the branch for statistical purposes.⁷⁸
 - . Every credit institution should have sound administrative and accounting procedures and adequate internal control mechanisms.⁷⁹
 - . Credit institutions must maintain at all times “own funds” at least equal to the amount of capital required at the time of initial authorization (generally EUR 5 million).⁸⁰
 - . Credit institutions must maintain permanently a risk-asset ratio of at least 8% to meet the solvency requirements.⁸¹
 - . Supervisory authorities of the member states shall require the credit institutions to report their consolidated and unconsolidated large exposures (i.e., risks in excess of 10% of the institution’s own funds)⁸². Such large exposures should not exceed 25% of credit institution’s own funds to a client or group of connected clients, nor 800% in total.⁸³
 - . Member States must ensure that the competent authorities may adopt or impose penalties in respect of a credit institution which breaches laws, regulations, or administrative provisions concerning the supervision or pursuit of its activities, or take measures aimed specifically at ending such breaches or their causes.⁸⁴

The competent authorities of the Member States must report to the Commission for any authorization of subsidiary of parent undertakings governed by the law of third countries.⁸⁵ Member States are free to establish stricter rules for credit institutions

⁷⁷ Ibid. Art.20

⁷⁸ Ibid. Art.22

⁷⁹ Ibid. Art.17

⁸⁰ Ibid. Art.5 (3)-(7)

⁸¹ Ibid Art.40-47

⁸² Ibid. Art. 48

⁸³ Ibid. Art.49

⁸⁴ Ibid. Art.32

⁸⁵ Ibid. Art.23 (1)

incorporated in their territory,⁸⁶ except that: (1) Host Member States may not require authorization or endowment capital for branches of credit institutions authorized in other Member States;⁸⁷ (2) Member States may not use the criterion of “economic needs of the market” in determining whether to authorize a credit institution.⁸⁸

3.4 Regulation on branches of third country banks

As defined in Art.1 (3) of the 2000 Directive, branch means “a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions”. Therefore a branch of third country bank is a dependent unit of a credit institution incorporated in a third country.

A branch of third country bank is authorized within the Community by the competent authority of each Member State. The branch can only provide service within the territory of the member state in which it is established. “The branches of credit institutions authorized in third countries do not enjoy the freedom to provide services under the second paragraph of Article 49 of the Treaty or the freedom of establishment in Member States other than those in which they are established.”⁸⁹ Therefore the branches of third country banks could not enjoy the benefit of the single banking license. Furthermore, since branches of third country banks are not legally independent entities, they cannot establish sub-branches.

The competent authorities must report to the Commission and the Banking Advisory

⁸⁶ Ibid. Preamble parag 12

⁸⁷ Ibid. Art.13

⁸⁸ Ibid. Art. 9

⁸⁹ Ibid.preamble parag 19.

The second paragraph of Art.49 of the Treaty provides: “The Council may, acting by a qualified majority on a proposal from the Commission, extend the provisions of the Chapter [i.e. services] to nationals of a third country who provide services and who are established within the Community.”

Committee of all authorizations granted to branches of third country banks.⁹⁰

To summarize, Community law makes an essential distinction between the establishment of a subsidiary within the Community by a third country bank and the establishment of a branch. Once authorized by the supervisory body of the country of incorporation, subsidiaries will enjoy the same freedom under the 2000 Directive to establish branches without further ado anywhere within the Community and to provide services under the principle of mutual recognition. The main issue for third country banks is the conditions for entry into the Community market, embodied in the notion of 'reciprocity', discussed above. In contrast to subsidiaries, branches of third country banks do not qualify for an EC single banking license and will not benefit from mutual recognition and the privileges associated with it. The activities of a branch of a third country bank will be limited to the territory of the member state where it is located and will be subject to the national legislation of that country.

⁹⁰ Ibid. Art.24 (2)

4 The Chinese Banking Industry

4.1 Historical background⁹¹

China had maintained a mono-bank system before 1979. The People's Bank of China (PBOC) undertook the roles of central and commercial banking. The whole business was regulated by strict cash and credit plans set by the central government to ensure the national production plans to be fulfilled. Banks were part of the administrative hierarchy.

In 1979, the PBOC functions were devolved to three specialized state-owned banks: Agricultural Bank of China (ABC), providing banking services for agricultural and rural industrial projects; Bank of China (BOC), conducting foreign exchange operations; and People's Construction Bank of China (PCBC), renamed as China Construction Bank in 1996 (CCB), providing loans for fixed assets investment. In 1984, the PBOC was officially designated the central bank and the Industrial and Commercial Bank of China (ICBC) was split from the PBOC and became the fourth specialized state-owned bank, focusing on the financing of commercial and industrial activities in urban areas.

In 1985, the restrictions limiting the four specialized state-owned banks to their own designated sector were lifted. The four banks were therefore allowed to expand their

⁹¹ Wong YC & Wong ML (2001) Competition in China's domestic banking industry, *Cato Journal*, Spring 2001 Vol.21, No.1

scope of business and to compete with each other in providing loans and deposit services.

In 1994, three policy banks were created to take over from the four specialized state-owned banks the task of extending policy loans: the China Development Bank to provide infrastructure financing, the Export-Import Bank for trade financing, and the Agricultural Development Bank for agricultural financing. These policy banks raise funds for directive policy lending through issuance of bonds. Thus the four state-owned banks were officially named “commercial banks”, under the Commercial Banking Law and Central Banking Law laid out in 1995. They were expected to be responsible for their own profits and losses but were still “encouraged” to extend loans to the state-owned enterprises and key projects.

Governed by the 1995 Commercial Banking Law, the objectives of the state-owned banks appear to be a combination of development and commercial goals. Article 34 of the CBL states, ‘A commercial bank shall conduct its loan business in accordance with the need for the development of the national economy and social progress and under the guidance of the state industrial policy’. Article 41 continues that, ‘A commercial bank owned solely by the state should provide loans for special projects approved by the state council’. The intended development objective the state-owned banks are to strive toward is that their lending should be supportive of state industrial policies.

At the meantime, there have been 13 joint-equity commercial banks established since 1986.⁹² The Bank of Communications was the first and the largest one. The Hainan Development Bank was closed in 1998 and China Everbright Bank acquired the commercial operations of the China Investment Bank from the China Development

⁹² These are the Bank of Communication, Shenzhen Development Bank, Guangdong Development Bank, China Merchants Bank, China Everbright Bank, China Minsheng Banking Corporation, Hua Xia Bank, Pudong Development Bank, CITIC Industrial Bank, Fujian Industrial Bank, Hainan Development Bank, China Investment Bank, Yantai Housing Saving Bank.

Bank in 1999. There are 11 joint-equity commercial banks now.⁹³

In the mid-1990s, local governments were allowed to establish local banks. Local urban cooperatives were restructured into city commercial banks taking the form of shareholding banks. Their business scope is restricted to their own localities.

4.2 The Chinese banking industry today

Even after two decades of economic transition and financial reforms, the four state-owned banks remain dominant in China's domestic financial sector. They have taken up the majority of total assets, loans and deposits. At year-end 1997 they accounted for 79.18 percent of loans and 72.83 percent of deposits in all financial institutions in China.⁹⁴ At year-end 1997, a survey of the world's 1000 largest commercial banks showed that ICBC, BOC, CCB and ABC ranked 22nd, 27th, 56th and 79th respectively according to asset size.⁹⁵

However, the joint-equity banks have grown faster than the state-owned banks since being established. Nevertheless, the fast grow of the city commercial banks and other financial institutions including foreign banks with branches in China are coming to front, not just because of their size but also because of their market orientation and business focus. Competition among the four state-owned banks and among the other commercial banks and foreign banks has intensified. The market share of the four state-owned banks had dropped gradually. At the end of 2002, the four state-owned banks accounted for 60.21 percent of loans and 65.08 percent of deposits in all

⁹³ China Banking Regulatory Committee (PBRC) website, April 28, 2004
<http://www.cbrc.gov.cn/chinese/module/viewinfo.jsp?infoID=197>

⁹⁴ Laurenceson .J. & Chai. (2001) State banks and economic development in China, *Journal of International Development*, 2001, 13, 211-225, primary data from People's Bank of China (1998) *China Financial Outlook*. China Financial Publishing House: Beijing. pp91-92

⁹⁵ *The Banker*, July, 1998, pp.131-134

financial institutions in China.⁹⁶ (Table 1)

Table 1. Concentration of Assets, Deposits, and Loans:

Four State-owned banks concentration ratios, 1994-2002

Year	Concentration Ratio (%)		
	Assets	Deposits	Loans
1994	93.04	90.14	93.24
1995	92.00	89.54	92.39
1996	88.90	87.08	90.42
1997	87.03	85.20	88.70
1998	84.93	84.26	88.51
1999	81.28	80.59	85.76
2000	78.81	78.02	80.93
2001	73.87	72.91	74.82
2002	65.56	65.08	60.21

Source: Calculated by the author based on data obtained from the website of PBOC, National Bureau of Statistics of China, China Banking Regulatory Commission, and the annual reports of the four state-owned banks.

By the end of year 2003, the banking financial institutions in China consist of 4 state-owned commercial banks, 3 policy banks, 11 joint-equity commercial banks, 4 assets management companies, 112 city commercial banks, 182 foreign banks, 209 foreign bank representative offices, 731 urban credit cooperatives, 35544 rural credit cooperatives, 3 rural commercial banks, 52 trust investment companies, 74 financial companies, 12 financial leasing companies and millions of post-saving offices all over China.⁹⁷ A detailed data has been shown in Table 2 below.

⁹⁶ Calculated by author based on the data obtained from the website of PBOC <http://www.pbc.gov.cn/baogaoyutongjishuju/2002S0.htm> (April.26, 2004) and the annual reports of the four state-owned banks

⁹⁷ China Banking Regulatory Committee (PBRC) website, April 28, 2004 <http://www.cbrc.gov.cn/chinese/module/viewinfo.jsp?infoID=243>

Table 2. Banking financial institutions in China by the end of year 2003

Total Assets and Liabilities of banking institutions in China						
By the end of 31 December 2003						
	Total assets			Total liabilities		
	(RMB billion)	Share (%)	% of GDP	(RMB billion)	Share (%)	% of GDP
Total	27639.45	100.0	236.85	26574.10	100.0	227.72
Policy Banks (3)	2124.70	7.7	18.2	2029.05	7.6	17.39
State-owned Commercial Banks (4)	15194.06	55.0	130.20	14576.20	54.9	124.91
Joint-equity Banks (11)	3816.97	13.8	32.71	3681.00	13.9	31.54
City Commercial Banks (112)	1462.17	5.3	12.53	1412.25	5.3	12.10
Rural Commercial Banks (3)	38.48	0.1	0.33	30.10	0.1	0.26
Urban Credit Cooperatives (731)	146.83	0.5	1.26	146.43	0.6	1.25
Rural Credit Cooperatives (35544)	2650.92	9.6	22.72	2664.62	10.0	22.82
Non-banking financial institutions (138)	910.00	3.3	7.80	768.26	2.9	6.58
Post-saving offices (N/A)	898.44	3.3	7.70	898.44	3.4	7.70
Foreign banks (182)	396.90	1.4	3.40	357.73	1.3	3.07

Note: 1. Post-saving offices are spread in every corner of China and the assets in the table include only the amount of savings. 2. The data include only domestic assets and liabilities of the financial institutions.

Source: China Banking Regulatory Commission website⁹⁸ 1 USD≈8.278 RMB

National Bureau of Statistics of China website⁹⁹

4.3 Chinese regulations on banking operation

China had adopted a mixed operation mode in the financial sector before 1993 when commercial banks are allowed to deal with investment and security business. Due to lack of regulations and supervision, all commercial banks and most of their major

⁹⁸ CBRC website <http://www.cbrc.gov.cn/chinese/module/viewinfo.jsp?infoID=197> accessed on April, 29,2004

⁹⁹ NBSC website <http://www.stats.gov.cn/>, accessed on April, 29, 2004

branches set up their non-bank financial institutions, such as finance companies, to engage in imprudent or fraudulent operations. Lots of funds were diverted into speculation in the stock market and finally lead to the stock market shock in 1992.

The Commercial Banking law, effective on 1 July 1995, stipulated that commercial bank can not engage in “ trust investment or share business, or invest in immovable property which is not for their own use.”¹⁰⁰ From then on, Chinese financial market was segmented into commercial bank market, security market, investment market and insurance market. The separate operation system in financial sector remains unchanged up to now.

Although significant reform has been taken in Chinese banking sector, the entire banking system is still under government control. Despite the control over scope of banking activities, there are some other administrative controls: (i) Credit plan. The Chinese central bank uses the credit plan as a main instrument to control the money supply. The credit plan defines credit ceilings for the state-owned banks for allocation of credit. (ii) Interest rate control. The central bank set up interest rates for both deposits and loans for domestic banks. The original reason for interest rate control was to control costs for state-owned enterprises. In recent years, the central bank has frequently used interest rates as an instrument to adjust aggregate demand.¹⁰¹

The People’s Bank of China, China’s central bank, has issued a directive in 1994, namely the ‘Directive of People’s Bank of China regarding implementing capital assets ratio management system for commercial banks’. The Directive set up the internal control criteria for commercial banks. According to that Directive, the capital adequacy ratio of the commercial banks should no less than 8%. The state-owned banks’ growth of credit loans should not exceed 75% of the average growth of

¹⁰⁰ Article 43 of China Commercial Banking Law

¹⁰¹ Ma, Jun. (1996) China’s banking sector: from administrative control to a regulatory framework. *Journal of Contemporary China*, Vol. 5, Issue 12, 155-170

deposits; long- and medium-term loans (with maturity equal to or longer than one year) should not exceed 120% of total long- and medium-term deposits (with maturity equal to or longer than one year). Ten-day average of liquid bank assets should not be lower than 25% of the ten-day average of liquid liabilities.¹⁰²

In April 2003, the China Banking Regulatory Committee (CBRC) was officially established to carry out the supervisory and authorization function in the banking sector. PBOC will continue to be the central bank focusing on making and implementing monetary policy.¹⁰³

As discussed in the previous chapter, Chinese bank's operation in EU is governed by home country legislation and host country legislation. Due to different legal status, branches' market access are affected by both home and host country legislation, therefore Chinese banks' branches in EU could only deal with commercial banking services in line with the business scope of their head offices. While subsidiary's market access is mainly determined by host country legislation therefore subsidiaries of Chinese banks in EU could engage in universal banking including insurance, security and investment business.

¹⁰² Ibid.

¹⁰³ CBRC website, <http://www.cbrc.gov.cn/>, accessed on April, 29,2004

5. The determinants of Chinese banks' FDI in EU

The previous chapters have examined the EU legal framework on third country banks and given some notes of the development of the Chinese banking industry. Synthesis of the main OLI factors of FDI in banking has been made in Chapter 2 based on the previous empirical studies. In order to test whether those factors hold true for Chinese banks FDI in EU, the author has conducted a detailed survey.

5.1 The survey

Three Chinese banks are operating 8 branches and 2 subsidiaries in EU (see Table 3 below). In order to clarify the motives and determinants of Chinese banks FDI in EU, on the basis of the preceding chapters, the author designed and utilized a questionnaire¹⁰⁴ in a survey-based interview of all these three banks that having branched and subsidiaries in EU.

The survey was conducted between April and mid May 2004. Because of the time limitation for the research, and in order to get more detailed information in depth and in width, the survey was made mainly via telephone interview. The questionnaire itself was targeted at the respective senior executives of the banks and was used to structure the interviews.

¹⁰⁴ See Appendix A

Table 3. Chinese banks' presence in EU

Chinese Bank's Presence in EU

(expressed in USD million)

Name of the bank	Form of establishment	Time of establishment	Asset by the end of 1996
BOC London Branch	Branch	1929	4000
BOC Luxembourg Branch	Branch	1979	1200
BOC Paris Branch	Branch	1986	1000
BOC Frankfurt Branch	Branch	1989	600
BOC Milan Branch	Branch	1998	N/A
CCB Frankfurt Branch	Branch	1999	270*
ICBC Frankfurt Branch	Branch	1999	325*
ICBC Luxembourg Branch	Branch	2000	561*
BOC International (UK) Limited	Subsidiary	1996	N/A
ICBC (London) Limited	Subsidiary	2003	N/A

* By the end of 2002

Source: website of BOC, CCB and ICBC

Since the author was herself a manager of International Business Department of one provincial branch of ICBC, it was easy for her to target the key person as respondent for conducting the survey based on the established private relations with ICBC, BOC and CCB. Interviews were made with executives who play the most important role in effective FDI decisions of the respective banks¹⁰⁵. More than one person was interviewed within each bank. The interviews commonly lasted one or one and a half hours.

The cooperation and support extended to the survey was a continual inspiration. In total, 9 key persons have been interviewed. There was only one case that the

¹⁰⁵ See Appendix B.

respondent did not answer the questions, stating confidentiality as the reason. But finally the information was obtained from interview of other respondents of the bank. The respondents and the answers covered all the branches and subsidiaries of Chinese banks in EU in terms of their responsibilities. In the following section, the answers of 8 respondents who have responded the questionnaire have been included and analyzed.

Due to the fact that there are only 10 branches and subsidiaries of Chinese banks in EU, it is impossible to make any variables or develop any model. But since the respondents of the survey were the key persons in charge of overseas operations of each bank, the personal interview proved to be useful to gain insight in the motives and determinants of Chinese banks FDI in EU.

5.2 The determinants of Chinese banks' operation in EU

As discussed in Chapter 2, the existence of ownership, location and internalization advantages (the OLI paradigm) is a necessary condition for FDI to occur. The decision by a MNB to enter into a foreign country is a function of the nature and strength of the bank's ownership and internalization advantages in conjunction with the expected location advantages of operating in that country. As the markets for knowledge and client relationships are imperfect, due to their public good and proprietary nature, a bank has incentives to internalize the ownership and location advantages through the establishment of an institution, namely a branch and/or a subsidiary, subject to the legal requirement of the host country. The OLI paradigm is now applied to the special case of Chinese banks' investment in EU based on the result of the survey.

5.3.1 Ownership advantages

Ownership advantages are of significant importance since they allow the bank to overcome the advantages possessed by their rivals and enable the bank to profit from extending its operations into other national markets.¹⁰⁶ Such competitive advantages may include large bank size,¹⁰⁷ Geographical diversification of banking networks,¹⁰⁸ large domestic capital and deposit base,¹⁰⁹ and extensive customer base.¹¹⁰

1. Large bank size, domestic capital and deposit base.

The author firstly tested the viewpoint that there is a positive relationship between the bank size, the domestic capital and deposit base, and its decision to go abroad.

Large-size and large capital and deposit base will allow the bank have signaling-related advantages because their strong commitment of their own funds to their lending decisions should be perceived as an indicator of asset quality.¹¹¹ ICBC, BOC, CCB are the three largest state-owned banks in China and they are in the world' largest 500 banks based on tier one capital (ICBC, BOC and CCB ranked No.10, No.11 and No.28 respectively in year 2002).¹¹² They possess a large domestic capital and deposit base, and their assets accounts for 45% of the total assets of all financial institutions in China at the end of 2002.¹¹³ Their assets account for 104.7% of the China's GDP in 2002.¹¹⁴ Their branches and subsidiaries in EU have the advantage to access to substantial foreign capital at low cost from their parent banks.

¹⁰⁶ Dunning, J. (1993)

¹⁰⁷ Dunning 1989,1993, Hultman & McGee 1989, Grosse & Goldberg 1991, Fisher & Molyneux 1996, Hondroyiannis & Papapetrou 1996

¹⁰⁸ Dunning 1989,1993, Cho 1986, Ursacki & Vertinsky 1992

¹⁰⁹ Yannopoulos, 1983, Cho 1986

¹¹⁰ Gray & Gray 1981, Yannopoulos 1983

¹¹¹ Ursacki & Vertinsky, (1992)

¹¹² published in ICBC, BOC, CCB website, ranked by *the Banker*, July, 2002.

¹¹³ Calculated by the author based on data obtain from website of ICBC, BOC, CCB and PBOC

¹¹⁴ Ibid.

As to the large capital base, these banks have their unique features. ICBC, BOC and CCB enjoy their special advantage of obtaining full support from the government, sometimes obtaining free cash flow from the government. The goal of the Chinese government is to achieve a “socialist market economy”. The state-owned commercial banks as a group continue to have a dominant share of the commercial banking business, accounting for more than half of the aggregate assets of all financial institutions after two decades of financial reforms (see table 1 and 2 above). Aimed to make the state-owned banks more competitive, several measures have been taken by the Chinese government. In 1998, the government issued special government bonds of 270 billion (USD32.6 billion) as capital injections to recapitalize the four largest state-owned banks. In 1999, the State Council set up four Asset-Management Companies (Huarong, Xinda, Great Wall and Orient) to buy, manage and recover the bad loans of the state-owned banks.¹¹⁵

In order to help the state-owned banks to become more competitive in the financial market, the Chinese government has taken significant steps especially after china’s entry to the WTO. At the end of 2003, 45 billion US dollar (just over tenth of Chinese total foreign-currency reserves) have been injected into BOC and CCB, two of the big four state-owned banks.¹¹⁶ The measure inevitably strengthened these two banks capital bases.

Due to the above-mentioned features, the largest state-owned banks have the ability to have their presence in EU market. No other Chinese banks, including the joint-equity banks, the city commercial banks, have their business offices in EU. As Mrs. Hou Qian (General Manager of Overseas Branching Dept. ICBC Head Office) pointed out during the author’s interview, small Chinese banks may have less needed resources and capital base to venture into foreign markets.

¹¹⁵ By the end of 2001, the total bad assets being bought by the Asset-Management Companies amounted to 14 trillion RMB (USD1.69 trillion). POBC website <http://www.pbc.gov.cn/quanwenjiansuo/index.asp> April 29, 2004

¹¹⁶ Spokesman at Press Conference of State Administration of Foreign Exchange (SAFE) on Jan. 6, 2004 <http://www.safe.gov.cn/News/N234.htm> April 29, 2004

Among the respondents (eight persons in total) by the survey, all of them confirmed that only the state-owned banks possess the advantages and abilities to expand abroad. Seven out of these eight respondents referred the large bank size and large capital base as the “advantage” for their banks’ FDI. Five of them indicated the domestic deposit base was also a positive factor.

The positive relationship between the bank size, the capital and deposit base, and the bank’s decision to go abroad holds true for the Chinese banks FDI in EU.

2. Extensive customer base and banking networks

Banks with a large customer base and banking networks will be able to reduce transaction costs by bringing together customers with offsetting needs. Generally speaking banks are likely to be at a disadvantage in information production when operating overseas due to their lack of familiarity with the local market, but the presence of customer group with which they are already familiar will help to overcome this and the established banking networks will also help.¹¹⁷ Previous studies suggest that extensive customer base and banking networks are two of the main competitive advantages of MNBs.

ICBC, BOC and CCB have established a substantial domestic branch networks. ICBC owns over 22034 business offices in China, BOC has 12090 and CCB 21000.¹¹⁸ Taking advantage of their business networks, they enjoy an extensive domestic customer base. Moreover, along with the foreign investment and the development of joint ventures in China, these banks have built widespread banker-customer relationships with multinational companies and established broad relationship with extensive customers abroad. Taking ICBC as an example, it owns over 8 million

¹¹⁷ Ursacki & Vertinsky, (1992)

¹¹⁸ data from Website of ICBC, BOC and CCB.

corporate customers and more than 1000 million individual customers in China. Up to now, ICBC has 71 business offices and stock-controlling banks in all major international financial centers around the world. The total foreign exchange assets reached 49.2 billion US dollars by the end of 2003.¹¹⁹

Besides the extensive domestic business networks, the Chinese banks have established a network in almost all the major international financial centers. BOC has a long history of dealing with foreign business. It owns now 581 business offices abroad with total assets 132.2 billion US dollars, accounting for 28.6 percent of BOC's total assets.¹²⁰ Furthermore, its oversea correspondent banks had reached 1,020.¹²¹ CCB has established 5 overseas branches as well. Its' overseas correspondent banks amount over 800 in 2003. The extensive domestic and overseas branch networks therefore become a competitive advantage of Chinese banks in EU against its rivals. Indeed, as EU is the third largest trade partner of China, it is the Chinese banks' domestic branch networks making the bank more competitive in EU market. The overseas branches' abilities are enhanced by their close links with the entire banking group.

The survey shows that the business of the branches of Chinese banks in EU has strong linkage with the domestic branches. Mr. Xiao Shaolin, General Manager of CCB Frankfurt Branch, indicated that 80% of the international settlement business of CCB Frankfurt Branch was transacted through other CCB branches, including domestic branches and CCB branches in other countries and areas. Some of the business is dealt together with the domestic branch, for example the syndicated loans. Moreover, due to the increasing import and export business between EU and China, the overseas branches can always provide valuable information to the domestic branches for some possible business opportunities and vice versa. Among the 8 respondents, 6 of them

¹¹⁹ ICBC website,
<http://www.icbc.com.cn/about/index.jsp?column=%B9%A4%D0%D0%B7%E7%C3%B2%3E%B9%A4%D0%D0%BC%F2%BD%E9> accessed May, 12, 2004

¹²⁰ Bank of China, Annual Report 2002

¹²¹ ICBC website homepage April 28, 2004

believed that the customer base and network advantages were very important factors, 2 of them admitted those factors were fairly important.

Therefore we can conclude that extensive customer base and banking networks are important determinants for Chinese banks FDI in EU.

5.3.2 Internalization advantages

Following Dunning's eclectic paradigm, banks as well as firms will internalize their ownership advantages in foreign markets when it is more efficient to engage in foreign direct investment than arm's length marketplace exchange. The bank-customer relationships consists primarily of flows of information and information inputs are difficult to obtain due to the protection of proprietary interests.¹²² Therefore the particular bank-customer relationships cannot be transferred into foreign markets through arm's length transactions. Dunning refers to this as 'cognitive imperfection', which arises whenever information about a product or service is not readily available or is costly to acquire.¹²³ Preserving established and obtaining on-going client relationships by opening foreign offices to follow their customers abroad become a means for protecting knowledge and information networks, thus achieving internalization advantages.

Additionally, the development of trade relationship between countries implies flows of goods and services across national borders. These flows require converting the currency of the importing country into the currency of the exporting country, which is facilitated by the presence of banking operations in loco.¹²⁴ Accordingly, the data shows that the bilateral trade between EU member states and China has positive effect on the Chinese banks' expansion in EU. (See Table 4 below)

¹²² Yannopoulos (1983)

¹²³ Dunning (1980)

¹²⁴ Gray & Gray (1981)

Table 4 Chinese Trade relationship with EU in 2003

(USD million)

Country	Imp.& Exp.	Export	Import	Increasing (comparing 2002)		
				Imp.& Exp.	Exp.	Imp.
Total	851,207	438,371	412,836	37.1%	34.6%	39.9%
Europe	162,086	90,330	71,756	43.8%	52.5%	34.3%
EU	125,217	72,155	53,062	44.4%	49.7%	37.7%
Germany	41,876	17,536	24,340	50.7%	54.2%	48.3%
Netherlands	15,439	13,505	1,934	44.6%	48.3%	23.1%
U.K.	14,394	10,824	3,570	26.3%	34.3%	7.0%
France	13,391	7,294	6,097	60.9%	79.1%	43.4%
Italy	11,733	6,653	5,080	28.3%	37.8%	17.6%
Belgium	6,702	3,934	2,768	36.8%	36.8%	36.9%
Spain	5,252	3,891	1,361	51.0%	50.9%	51.2%
Sweden	4,169	1,453	2,716	54.3%	59.7%	51.6%
Finland	3,462	1,674	1,788	29.8%	45.1%	18.2%
Denmark	2,458	1,494	964	58.2%	63.0%	51.4%
Ireland	2,343	1,392	951	60.5%	80.7%	38.0%
Austria	1,779	674	1,105	29.4%	40.0%	23.7%
Greece	1,188	1,114	74	51.0%	52.2%	35.6%
Portugal	601	406	195	57.7%	35.1%	135.3%
Luxembourg	427	311	116	321.6%	507.1%	131.2%

Source: Ministry of Commerce of People's Republic of China website¹²⁵

Due to the lack of data of the trade volume between different EU member states and China in previous years, the paper could only present the data for year 2002 and 2003. However, we can still, from these data, understand the general situation about the

¹²⁵ MCPRC website, http://ozs.mofcom.gov.cn/article/200402/20040200176082_1.xml accessed April, 19, 2004

trade relationship and the developing trend between different EU member states and China. Among ten branches and subsidiaries of Chinese banks in EU, 3 of them were set up in Germany, 3 in U.K., 2 in Luxembourg, 1 in France and 1 in Italy. All these countries are the largest trading partners of China among EU member states. Besides the ‘special attractiveness’ on banking, Luxembourg’s trade with China grows rapidly although the total volume is relatively small. The data indicates that Chinese banks are following international businesses in the process of overseas expansion. When the foreign trade volume increase and customers go abroad, the banks follow them and depend on the information about them which it already possesses quickly and at lower cost. Therefore it has the better ability than others to respond to its customers’ needs and achieve the internalization advantage. The result of the survey confirmed this as well. 8 respondents indicated that the bilateral trade contributes to the bank’s FDI decision. 6 of them thought the bilateral trade was the most influential factor for the bank’s expansion in EU.

5.3.3 Location advantages

Location advantages are important factors in the country choice of multinational banks. Location advantages, relative to the location disadvantages of host country, will help determine how well the multinational bank can exploit its ownership and internalization advantages. This eventually affects the bank’s performance after entry. Previous studies suggest that the location advantage may include: local banking opportunity in the host country;¹²⁶ the presence of an international financial center in the host country;¹²⁷ the extent of regulation of banking activities in the host country relative to the multinational bank’s home country.¹²⁸

¹²⁶ Sabi 1988, Goldberg & Saunders 1980, Goldberg & Grosse 1994, Goldberg & Johnson 1990.

¹²⁷ Ursacki & Vertinsky 1992

¹²⁸ Gray & Gray 1981, Yannopoulos 1983, Ursacki & Vertinsky 1992

1. Financial center advantage and banking opportunities

Banks are enterprises. The goal of the bank is to achieve maximum profit. Thus the bank is always attracted to foreign markets to take advantage of local banking opportunities.¹²⁹ According to Gray and Gray,¹³⁰ banks are tending to enter markets where they can exploit their information and technology advantages. Therefore a country that hosts an international financial center provides more efficient banking product opportunities.

The survey shows that the presence of the important international financial center in EU is a crucial attractive factor for the Chinese banks' FDI. A synthesis of the answers obtained during the survey suggest that: First of all, the financial center has high level of development of banking system and high efficiency thus it provides an environment for Chinese banks to diversify their products. Secondly, the size of capital market of the financial center is much higher than others therefore it provides more investment opportunities. As indicated by Mrs. Hou Qian, General Manager of Overseas Branching Department of ICBC Head Office, for ICBC's branches in EU (one in Frankfurt and one in Luxembourg), their business in capital market has grown rapidly and the investment income constitutes more than half of their total income. Interest income from syndicated loan and investment income consist of the main stream of income source for BOC's branches in EU, as introduced by Mr. Zhong Xin, Manager of Overseas Institution Management Department of BOC Head Office. This is in significant contrast with the situation of BOC's domestic branches where the traditional bilateral loan is the main business and the interest income from the bilateral loan accounts for over 70% of the total income of the domestic branches.¹³¹ Thirdly, whole business opportunities are higher due to the wealth and size of the local market of the financial center. Last but not least, Chinese banks have a strong motive to have presence in the world major financial center. 5 respondents have

¹²⁹ Goldberg & Saunders, (1980)

¹³⁰ Gray & Gray, (1981)

¹³¹ BOC website, http://www.bank-of-china.com/news/news2004/news04_029.html

mentioned that the bank's presence in the international financial center is not only a symbol of the banks' level of internationalization, but also a symbol of implementing the Chinese government's 'going out' strategy. To the Chinese banks, having presence in the major financial market is a means to gain reputation.

2. Regulation on banking

The survey shows that simplicity is one of the primary considerations for the Chinese banks to invest in EU, especially for CCB and ICBC (BOC has a longer history of operating abroad and it has more administrative experiences). Taking administration and supervision into consideration, the Chinese banks prefer to devise the simplest possible structure to establish overseas branch rather than to establish subsidiary. They consider equity to be the most expensive form of funding they must secure. Therefore there is a strong incentive to explore legal structures to minimize the level of equity they must hold in the context of cross-border commitments. Thus the banks want to operate where possible through a branch structure rather than subsidiaries.¹³² Capital requirements are normally less for a third country branch than those of a subsidiary fostering the same kind of business because a branch is 'protected' by the total capital of the entire bank (the establishment of branch of an EU bank does not require any capital endowment, but this is not the case for third country branch). A branch will have a more efficient capital structure than a subsidiary. As a dependent unit of the head office, branch has privilege over subsidiary in raising funds and issuing bond because the branch conducts these businesses in the name of head office. It is much easier for a bank to borrow money in international financial market through its branch than subsidiaries. According to Mr. Wu Bin, General Manager of ICBC Luxembourg Branch, the preference for branch is also because of the scope for greater diversification of risk exposures in a larger entity (the entire bank) rather than a smaller one (subsidiary) where risks can all too readily be concentrated in a few major

¹³² For further theoretical explanation, see Hogan, W.P. (2003) Taxation and international banking. *International Review of Financial Analysis*, 12, 467-487.

activities and diversity constrained.

Nevertheless, the Second Banking Directive and the liberalization of European financial market provide many business opportunities to Chinese banks. The Second Banking Directive (89/646/EEC) established the single banking license and the mutual recognition principles that facilitated market access. The single banking license allowed any banks which were authorized to act as such in a member state to set up branches or to supply cross-border services in other EU countries, without having to obtain further authorization from the host country.¹³³ It provides unrestricted access for non-EC banks into any EC country to open branches and provide banking services (i.e. “a single passport”). Furthermore, it provided activity guidelines that allow all EC credit institutions to provide a broad range of financial services and confirmed that the EC has adopted the universal banking model. Thus subsidiaries of non-EC banks incorporated in EC countries are considered as EC institutions and thus are allowed to provide full range of service throughout Europe.

Universal banking activities are applied to subsidiaries, not to third country branches, which must adhere to home country banking regulations. This is the main incentive for BOC and ICBC to establish subsidiaries in EU. There are two subsidiaries of Chinese banks in EU, one is BOC International (UK) Limited established in 1996, another is ICBC (London) Limited established in 2003. Both of them were established after the adoption of the Second Banking Directive. At present, Chinese banking system adopt the separate operation mode. The adoption of the universal banking model in EU provided Chinese banks with an incentive to establish subsidiaries capable of engaging in investment banking operations, securities and insurance business. To establish subsidiary is a means to use the existence of universal banking in EU as a proxy for product market opportunities that are unavailable to Chinese banks in their home market. By establishing a subsidiary the Chinese banks could

¹³³ Art.19 of Directive 89/646/EEC

escape domestic regulations of not allowing universal banking and enhance product diversification by participating in a broader range of financial activities to increase the breadth and depth of products and thus maximize profitability within a host country. And simultaneously it could help to improve geographic diversification.¹³⁴

Therefore, it confirms the regulation on banking could be a determinant of FDI in banking. And indeed the Second Banking Directive is the determinant of Chinese banks' FDI in EU to establish subsidiaries.

To summarize, the results of the survey confirms the previous empirical evidence put forward in the international literature with reference to other countries.

¹³⁴ Miller, S.R. & Parkhe A. (1998). Patterns in the expansion of U.S. banks' foreign operations. *Journal of International Business Studies*, 9, 359-390

6. Conclusion

The increasing important economic and financial role that China is playing and will play in the world is leading and will lead to more studies on the development of the banking sector in China. The dramatically increased EU-China trade relationship has greatly accelerated the expansion steps for both parties to penetrate to each other's financial market.

However, the determinants of Chinese banks' FDI in EU have received little research concern. The author tried to analyze the dominant factors affecting Chinese banks' FDI in EU based on the survey and the relative data obtained.

The study result provides support that the Chinese banks expansion in EU can be usefully explained by the eclectic paradigm. The survey shows that the Chinese banks direct investment in EU depends significantly on: (1) ownership advantages related to the bank's size, domestic capital and deposit base, the customer base and the banking network; (2) the need to follow their clients in order to exploit their pre-existing bank-customer relationships; and (3) the access to externalities offered by the international financial center in EU and the positive business opportunities provided by the favorable banking regulation, especially the Second Banking Directive.

Nevertheless, a peculiar way for Chinese banks expansion in EU does not seem to emerge. The state-owned Chinese banks are only acting as a significant role within China but their position within the international banking system is still weak. The

underlying problem may exist in the ownership structure of the state-owned banks. A main characteristic of the state-owned Chinese banks is their ‘solely’ ownership by the state. And the government support and capital injection could not get things done once and for ever for a sound banking performance and further development. “A firm attempting to gain a global cost and availability of capital needs to attract international investors to purchase and hold its securities”.¹³⁵ How to restructure the ownership composition of the state-owned banks is of vital importance therefore it may need further research concerns.

¹³⁵ Oxelheim. L., Randoy. T., & Stonehill A. (2001) *On the treatment of finance-specific factors within the OLI paradigm*. Working paper No.554, 2001. IUI, The Research Institute of Industrial Economics. Stockholm

Appendix A:

Investigation on the main factors affecting the Chinese banks' FDI in EU

1. What is your bank's special advantage to invest in EU? Are there any factors that may make your bank more competitive against the rivals in EU? If yes, what are those factors?
2. What is the main initiative for your bank to invest in EU? (For example for customer-seeking, customer-following, obtaining a foothold or government motives)
3. What are the determinants for the location choice in EU? (For example, the access to major financial center, a favorable tax treatment, more banking opportunities)
4. Do your bank have any specific strategy for FDI in EU?
5. What kind of service can your bank branch/subsidiary in EU provide? What is the most profitable business? What is the customer's favorable product?
6. What is the feasible organization form for your bank's FDI in EU? Why do your bank choose that form?
7. When making the FDI decision, does your bank view EU as a single market or the Euro Zone as one market, and the rest as another? Why?

Appendix B:

Persons have been interviewed (by telephone):

ICBC

Mrs. Hou Qian, General Manager of Overseas Branching Dept. ICBC Head Office (April, 20, 2004; May 12, 2004)

Mr. Zhang Kexin, Managing Director & CEO of ICBC (London) limited (April, 20, 2004; May 12, 2004)

Mr. Wu Bin, General Manager of ICBC Luxembourg Branch (April, 19, 2004)

CCB

Mr. Guo Huaiwei, Manager of International Dept. CCB Head Office (April, 22, 2004; May, 18, 2004)

Mr. Xia Guijun, General Manager of Overseas Branching Dept. CCB Head Office (April, 21, 2004)

Mr. Xiao Shaolin, General Manager of CCB Frankfurt Branch (April, 21, 2004)

BOC

Mr. Zhong Xin, Manager of Overseas Institution Management Dept. BOC Head Office (April, 22, 2004; May, 12, 2004)

Mr. Zhang Baoqiu, Manager of International Dept, BOC Head Office (April, 22, 2004)

Mr. Ma Ning, General Manager of BOC London Branch (April, 22, 2004) (refused to answer the question due to confidential reason)

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