

Banking Reform in the Chinese Mirror

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Abstract:

This paper analyzes the transactions that led to the partial privatization of China's three largest banks in 2005/06. It suggests that these transactions were structured to allow for inter-organizational learning under conditions of uncertainty. For the foreign investors involved their participation in large financial intermediaries of central importance to the Chinese economy gave them an opportunity to learn about financial governance in China. For the Chinese banks partnering with more than one foreign investor allowed them to benefit from the input by different players in the global financial market place and to learn from the range of technical and governance expertise they offered. This model of bank reform contrasts with the privatization strategies pursued in Latin America and Central and Eastern Europe throughout the 1990s. These different experiences stand for alternative strategies of bank reform: One that relies on top down changes of the rules of the game; and another that focuses on inter-organizational learning by monitoring. It suggests that the latter model may be superior under conditions of uncertainty. The paper discusses the costs and benefits of these alternative models in the context of the global financial crisis.

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I. Introduction

Banking and financial sector reforms have proved to be challenging undertakings for domestic reformers and policy advisors around the globe. Many reform attempts have gone astray as the chosen strategy failed to take account of the institutions and incentive structures the newly privatized, merged, acquired, or re-capitalized banks would operate under. Eastern Europe and Latin America are replete of cases where banks had to be recapitalized more than once,² or where bank privatization gave rise to government bailouts or outright re-nationalization, only to be followed by another round of privatization.³

Against this background China's approach to banking reform stands out as unique among emerging markets with a recent history of financial sector reform. Rather than privatizing banks and transferring control to foreign investors – the dominant strategy in Eastern Europe and most of Latin America – China sold minority stakes in three of its largest banks to a group of selected foreign strategic investors.⁴ In each case at least 2 foreign investors with different business profiles acquired substantial minority stakes prior to the public offering and typically committed to buy additional shares in the public sale. The government retained control and the remaining shares ended up in the hands of a range of investors, including other publicly controlled entities as well as individual investors. Foreign financial intermediaries were sought as strategic partners for helping to transform China's banks and making them competitive both at home and abroad. This

² On banking sector reforms in Eastern Europe (Rostowski 1995) and (Buch 1996)

³ This has been the case, for example, in Mexico. On the volatility of financial sectors in emerging markets, see (Feldstein 2002) as well as (Ocampo 2001)

⁴ (Leigh and Podpiera 2006)

task became all the more urgent as China had committed to open its financial service sector by the end of 2006.⁵

This paper analyzes how these transactions have helped reform China's banking sector and facilitated the transformation of state controlled bank behemoths used primarily to channel financial resources to targeted sectors in the economy into viable financial intermediaries capable of competing globally. It argues that the transactional model facilitated inter-organizational learning that has translated in tangible results in at least two of the banks in questions. The paper also notes that a series of transactions between sovereign wealth funds (SWFs) from China, Singapore, and the Middle East with Western banks since 2007 have adopted very similar transactional models. This calls for a better understanding of alternative transactional models and their implications for institutional change.

The paper is organized as follows. Part II describes the transactions that were central to the partial privatization of China's three large banks in 2005/06 and contrasts this model with the privatization experience in Central and Eastern Europe. Part III develops two (qualitative) models of banking reform, one based on the transfer of control, the other based on learning by monitoring. Part IV applies the insights gained from these models to transactions between sovereign wealth funds (SWF) and Western banks during the global financial crisis. Part V concludes.

⁵ For a discussion of the challenges China faced under WTO requirements, see (Bonin and Huang 2001)

II. China's Bank Deals vs. Privatization Strategies

Like other socialist countries China inherited a mono-bank system unsuited for the tasks of transforming a centrally planned economy into one based increasingly on market principles, even if under state guidance.⁶ As other countries, China began the transformation by breaking up the mono-bank and establishing several specialized banks: The Agricultural Bank of China (ABC), the Bank of China (BOC), and China Construction Bank (CCB). The Industrial and Commercial Bank of China (ICBC) was added in 1985. Until the mid 1990s, China's "Four Big Banks" operated under direct guidance and control of the central government. Their roles can be better described as resource allocators than financial intermediaries. Beginning in the mid 1990s, however, China's banks were pushed towards intermediation. They were instructed to operate as commercial banks and become accountable for profits and losses they incurred.⁷ These measures encouraged the banks to explore new market segments, including consumer credit and lending to the non-state sector. However, they remained heavily exposed to the state owned enterprise sector, and as a result, were saddled with substantial amounts of non-performing loans (NPLs). Estimates on the ratio of NPL vary with different sources putting it at between 27 and 44 percent in the year 2001.⁸ China sought to tackle the NPL problem by creating several asset management companies (AMCs) that bought NPLs from designated banks at a discount with the plan of subsequently selling them on the

⁶ See (Nanto and Sinha 2002) for a summary of China's banking reforms.

⁷ Another way of putting this is to say that the budget constraint of these banks was hardened. See (Kornai, Maskin, and Gerard 2003) for an overview of the soft budget constraint syndrome and (Berglof and Gerard 1998) for its application to the transition context.

⁸ See Nanto and Sinha (2002) supra note 6 at 479 quoting the Chinese government and Bank of China as sources for these estimates. Note that the authors put the comparable ratio of NPLs in Asia prior to the East

market. Being unable to sell all assets on the underdeveloped Chinese markets AMC's soon sought foreign investors. China Huorong AMC, one of the four major AMC's that was matched with ICBC, managed to sell large chunks of its portfolio of NPLs to an international consortium led by Morgan Stanley, and another chunk to Goldman Sachs.⁹

The purchase of non-performing assets from AMC's by Western banks can be considered a first step in a series of transactions that created relational ties between Chinese and foreign financial intermediaries. The second step was the acquisition of significant minority stakes by Western banks in three of China's four big banks in 2005/06.¹⁰ CCB, BOC and ICBC each negotiated a private placement of shares with strategic foreign investors prior to offering their shares to the public and listing the companies on the Hong Kong stock exchange.¹¹ Table 1 below lists the financial intermediaries involved and the stakes they acquired at the outset. It also indicates the size of the block that remained in direct government ownership and the government controlled entity in charge.

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When these transactions were formed, observers puzzled over the eagerness of Western banks to invest billions of dollars in these large banks with a history of

Asian Financial crisis at 70 percent of Indonesia, 35 percent for Korea, 30 percent for Malaysia, and 50 percent for Thailand.

⁹ Ibid. Note also that Goldman Sachs later became an investor in ICBC.

¹⁰ China's Agricultural Bank (ABC) was slated for commercialization and subsequent (partial) privatization only in the fall of 2008.

¹¹ Bank of China launched an IPO of (domestic) A shares on the Shanghai stock exchange in 2006. CCB was listed on the Shanghai Stock Exchange in 2007.

corruption and mismanagement and continuing state control.¹² The dominant explanation was that Western banks were trying to secure a foothold in the world's fastest growing market and were willing to pay a steep entry fee to this end.¹³ Still, this does not explain the motives on the Chinese side. A full account of these transactions needs to rationalize the motives of both parties, i.e. foreign banks *and* China's policy makers. An important motivation for China's policy makers may have been to secure the success of the initial public offering by getting foreign investors to essentially back the offering price. This explanation puts foreign financial intermediaries in the role of a stalking horse for raising capital in the subsequent capital offering – a role they may have not been willing to play without other rewards. Indeed, other features of the transactions suggest that this is unlikely to have been the exclusive motivation. Equally important for China's policy makers was to engage foreign institutional investors in reforming China's banking sector and to enhance its domestic and global competitiveness, without, however, transferring full control rights to the foreign investor.

Several features of the deals speak in favor of a conscious strategy of engagement without transferring control.¹⁴ First, foreign investors were offered a minority stake that ruled out control, but exceeded that of a portfolio investor. With between 5 and 9 percent of total outstanding shares they had a fairly large exposure to the bank. That reduced the likelihood of exit and increased the propensity of foreign investors to transfer knowledge

¹² See Min Xu, *Feeding frenzy for overseas banks*, Asia Times Online Ltd, September 30th, 2005. Available at http://www.atimes.com/atimes/China_Business/GI30Cb03.html (last visited 23 May 2008).

¹³ David Barboza, "China bank becomes a giant worth \$70 billion", The International Herald Tribune, 28 October 2005.

¹⁴ For a summary of the transaction between Goldman Sachs and ICBIC, see Goldman's 8-K filing No. 001014965 of 27 January 2006 available at www.sec.gov. The deal features between BofA and CCB are contained in a news release of CCB "Bank of America to invest US\$3billion in and form strategic partnership with China Construction Bank", available at www.ccb.cn. For RBS investment in BOC see

and expertise in order to enhance returns on their investment. Second, the foreign minority investors agreed to lockup periods typically of three years during which they could not sell their shares without consent of the company's management and/or the controlling owner. In other words, foreign investors were asked to tie themselves to these investments for a limited period. Third, foreign banks were given an option to increase their stake to a maximum of 19.9 percent after the lock-in period had expired, allowing them to reap the benefits of their investments at a future date. Finally, investors holding shares beyond a critical threshold (i.e. 2.5 percent) were given the option of nominating directors to the board of directors of the bank they had invested in.

The model stands in stark contrast to the dominant transactional type that Western banks have used throughout the 1990s when acquiring financial institutions in emerging markets around the world. In most cases, the Western banks acquired a majority stake, and frequently bought out domestic banks completely. A typical example is Santander's acquisition of controlling stakes in countries throughout Latin America, or Citigroup's acquisition of the Mexican banking group Banamex in 2001, which turned Banamex into a 100 percent owned subsidiary of Citigroup.¹⁵ Similar transactions occurred throughout Latin America and Eastern Europe. As a result in many countries in these regions the banking sector is now majority controlled by foreign banks: According to the Bank for International Settlement (BIS), as of 2002 the share of total bank assets controlled by foreign investors in Latin America ranges from 27 percent in Brazil to 82 percent in Mexico. In Eastern Europe the range is between a "low" of 63 percent in Poland to 99

RBS' news release "RBS announces formation of strategic partnership with Bank of China", 18 August 2005, available at http://rbs.client.shareholder.com/investor_relations/

¹⁵ See (Guillén and Tschoegl 1999) for a detailed account of foreign banks in Latin America in the 1990s. See also (Tschoegl 2002)

percent Estonia.¹⁶ The foreign banks that acquired domestic banks in Latin America and Eastern Europe were predominantly from the US and Western Europe.¹⁷

There are varying accounts of the success of this model – and final judgment will probably have to await the fallout from the ongoing global financial crisis. Some studies suggest that the profitability of banks under foreign ownership increased, and that foreign bank presence has had a positive impact on the real sector.¹⁸ Other studies point out that foreign owned banks contribute little to financial market development in the host country. Instead they tend to lend to governments or entities that are too big to fail, since they lack familiarity with local conditions to expand into more risky credit markets.¹⁹ The global financial crisis has exposed yet another risk of this strategy, namely the impact the failure (or government bail out) of the foreign parent bank can have on its subsidiaries in emerging markets, and by implication, on the financial systems and real economies in these countries.²⁰ Such an event can be particularly damaging in countries whose banks have become part of an internal capital market of a foreign parent bank. When this bank succumbs to a crisis, this negatively affects their subsidiaries.²¹

Against this background, China’s policy makers have opted for a middle ground. They encouraged foreign investment, but retained control and with it the ability to monitor closely the engagement of foreign investors and the impact of their strategies on the banks in question and their role in the domestic as well as the global financial market

¹⁶ See ((BIS) 2004) esp. Table 1 at p. 9 for details. Note that the share of foreign assets was only 9 percent in Russia, which the BIS included in its category of “Eastern Europe”.

¹⁷ Ibid at p 5.

¹⁸ (Bruno and Hauswald 2008)

¹⁹ (Mian 2006)

²⁰ This has prompted a joint effort by the EBRD and the World Bank to come to the rescue of the East European financial sectors. See the “IFI Joint Action Plan in Support of Banking Systems and Lending to the Real Economy in Central and Eastern Europe”, available at www.EBRD.com.

place. While China's banks have not been immune from the crisis, and indeed, some foreign banks sold their stakes in China's banks, the decision to engage more than one strategic investor has limited their dependence on a single investor.

III. Banking Reform: Assessing Alternative Strategies

Financial sector reform is primarily about institutional change, i.e. the reshaping of sustained collective expectations of key actors in charge of decision-making inside banks, but also of regulators and other policy makers from the outsiders.²² Yet, one of the unresolved puzzles of institutional development is how institutional learning takes place and how it might help a country to move off an existing institutional path²³ that has failed to deliver economic growth and development. The subsequent section discusses two approaches and offers evidence on how they have fared in the context of financial sector reform: changing the rules top down; and inter-organizational learning by monitoring.²⁴

Changing the Rules Top Down

One approach to institutional change is to change the rules of the game in a top down fashion by transferring control rights to new owners and enacting new laws and regulations. Transferring ownership from state to private hands is said to alter the

²¹ For empirical evidence on internal capital markets between parents and foreign subsidiaries, see {De Haas, 2008 #3112}

²² This definition of institutions builds on Aoki (Aoki 2001) and (Greif 2006).

²³ On the path dependence of institutional development see in particular (North 1990)

²⁴ The term "learning by monitoring" has been coined by (Sabel 1995)

incentive structure by promoting more efficient use of assets.²⁵ Moreover, a new owner can bring much needed capital and expertise to a firm, or in this case, a bank. This has been the underlying philosophy of privatization policies in Latin America and Eastern Europe in the 1990s aimed at promoting the restructuring of firms and transforming the economies in which they operate.²⁶ It is based on the assumption that a change in control will alter the modus operandi at the bank and that new owners will take decisions that will put a bank on a more efficient path. The model has dominated banking reforms in Eastern Europe as well as Latin America, where privatization and transferring control to foreign banks became the primary policy strategy. As a result foreign banks dominate these markets today.²⁷

The strong presence of foreign banks has had some positive impact on overall bank performance. However, the impact on financial market development, in particular on the broadening and deepening of financial markets in these countries is less certain.²⁸ Available evidence suggests that in transition economies they focused primarily on three market segments: foreign firms primarily from their home jurisdictions,²⁹ consumer

²⁵ This is the conclusion drawn by property rights theories. Whether this insight translates to more complex ownership relations in organizations has been questioned. See, for example, (Kornai 1990)

²⁶ See (Cooter 1992) and (Worldbank 1996).

²⁷ See supra note 17 and accompanying text.

²⁸ A recent paper suggests that foreign bank presence positively affects growth in the real sector. However, the impact of foreign bank presence on financial market development depends on the relative level of development of the country in question. Foreign banks are less important in the presence of well established financial markets, but can help alleviate financial constraints in less developed ones. See (Bruno and Hauswald 2008) for details. The study concludes that foreign bank ownership is only one strategy for financial market development, and that efforts to foster domestic markets and appropriate institutional reforms are also important. Ibid at 21.

²⁹ According to a survey conducted by Berger et al., foreign investors in Eastern Europe continue to prefer dealing with banks from their home jurisdictions when operating abroad, whereas they have switched to domestic banks in other markets. See (Berger et al. 2003)

lending, especially mortgage lending;³⁰ and lending to the government.³¹ In contrast, foreign banks appear to have been less important for lending to the enterprise sector.³²

One of the many lessons of the privatization policies of the 1990s has been that privatization is not enough for transforming an economy. In addition to changing ownership, the institutions that underpin a market economy must be created. That requires extensive legal and regulatory reforms.³³ The transfer of ownership was therefore complemented with an infusion of ‘best practice’ legislating and regulating from countries with a demonstrably successful economic track record. These efforts received a major boost with the East Asian financial crisis of 1997/98. Many observers attributed the crisis to defects in the institutions of the countries in question,³⁴ which in turn let the IMF to launch a major new initiative to develop a sound “international financial architecture.”³⁵ Countries around the globe were assessed against a set of indicators for sound rules on corporate governance, bankruptcy, the regulation of securities as well as of financial intermediaries.

The efficacy of this strategy has been questioned even prior to the global financial crisis that started in 2007,³⁶ which has shed further doubts on it. This time the crisis erupted in those countries that had served at least as the implicit model for best practice

³⁰ See (Haselmann, Pistor, and Vig 2009)

³¹ (De Haas, Ferreira, and Taci 2007) using survey data from 20 transition economies. (Haselmann, Pistor, and Vig 2008) confirm the finding for consumer lending, but don’t find evidence on expansion of lending to governments. Note, however, that they examined lending behavior as a function of changes in the legal regime for creditor rights rather than overall lending patterns.

³² Note, however, that a recent study suggests that the presence of foreign banks in transition economies has enhanced the prospects of SMEs to obtain external credit. See (Giannetti and Ongena 2009)

³³ For an early exposition of this point see (Pistor 1995). The insight that law ‘matters’ has given rise to the law and finance literature initiated by (La Porta et al. 1998).

³⁴ See, for example, (Johnson et al. 2000). Critical, however, (Radelet and Sachs 1998) and (Shin and Chang 2005)

³⁵ See (IMF 2003)

³⁶ See, for example, the self-critical review of the World Bank of its reform strategies throughout the 1990s (Worldbank 2005). For a critical review, see (Rodrik 2006)

reforms over the past ten years, the UK and the US. Some of the business practices that have contributed to the crisis, such as an emphasis on consumer lending and the extensive use of asset backed securities,³⁷ have indeed been transferred to emerging markets – and may explain much of the increase in available credit, at least in the short term. Improving legal institutions in the host countries appears to have exacerbated this trend. There is substantial evidence, for example, that improvements in collateral regimes – institutional reforms that have been high on the agenda of the World Bank and the EBRD³⁸ - have enhanced foreign bank lending volume in transition economies, particularly mortgage lending to households.³⁹ This would suggest that reliance on a single best practice model is an ill-fated strategy given that the sustainability of that model may not be known ex ante. Moreover, the transfer of standardized law and regulatory regimes cannot substitute for developing governance mechanisms for financial markets that are adapted to local circumstances and responsive to changes therein. Imported legal standards may fit only uneasily into pre-existing institutions. In fact, many complementary institutions that are easily available in the exporting country may be absent in the country that imports ‘best practice’ standards from abroad.⁴⁰ Legal standards need to be adapted over time to respond to changing circumstances. As argued elsewhere,⁴¹ law is inherently incomplete, i.e. unable to anticipate all future events. Effective law therefore relies heavily on a proper allocation of lawmaking and law enforcement powers and their use by local agents. This suggests that legal and regulatory reform can be only a partial solution to the problem of financial sector reform. As stated above, the key to successful reforms is

³⁷ For a critical review of derivatives see (Partnoy and Skeel 2007)

³⁸ (Summers 1997)

³⁹ See Haselmann et al. and De Haas et al., supra note 28.

⁴⁰ (Pistor 2002)

altering the collective expectations for conducting financial and economic relations. While property and legal reforms may signal that such a change is intended, the implementation of this formal, top down, change requires buy-in by key actors in the market, within organizations, as well as at law enforcement agencies. Upon closer scrutiny, the top down approach that was expected to shift economies to a new mode of economic organization turns out to be a rather indirect strategy to achieve institutional change, which ultimately depends on changing behavior on the ground.

Learning by Inter-Organizational Monitoring

An alternative approach to institutional change is to encourage institutional learning by actors in one economic system or organization from counter parts elsewhere. This approach rests on a very different understanding of the processes of institutional change than the best practice approach discussed above. It is actor based, in the sense that it assumes that institutional change requires actual change of behavior of individual actors.⁴² It is based on the notion that such behavioral change is more likely to be achieved by engaging actors in the process of change rather than by confronting them with new policy guidelines enshrined in formal law in the development of which they did not take part. And finally, it requires learning not only on the part of the recipient of foreign capital and expertise, but also on the part of the providers of these inputs.

The transactional model for the China bank deals described above creates incentives for cooperation without sharing control: Foreign intermediaries were to transfer operational and business skills while receiving an opportunity to familiarize

⁴¹ (Pistor and Xu 2003)

⁴² See (Greif 2006) for a behavioral account of institutions.

themselves with the operation of China's financial markets and governance regime. The lock-in period ensured that foreign investors would invest in this venture and not cash in their capital gains when the first opportunity arose. The option to increase their stakes at a future point nonetheless allowed them to participate in the long-term returns of their investments. Finally, the option to nominate non-executive directors, albeit falling short of giving minority investors a strong 'voice',⁴³ afforded them insights into the decision making processes at China's state controlled entities. This information is likely to have currency beyond the deals at hand especially for banks with plans of future expansions with or without government partners.

The task for policy makers is also quite different in the two models. In the best practice model, their major task is to identify best practices and encourage the drafting and passage of legislation that reflects these standards. In the learning by monitoring model policy makers set parameters for the transactions that instills a process of inter-organizational learning. If properly structured, monitoring and learning can become an integral part to a transaction that also delivers economic benefits, such as a positive return on an investment. As Sabel has put it, "discrete transactions among independent actors become continual, joint, formulations of common ends in which the participants' identities are reciprocally defining."⁴⁴

The bank deals described above can be viewed as an attempt to structure deals in order to encourage transactional learning by monitoring. The channel through which learning by monitoring takes place is the collaboration on specific projects inside the bank as well as board representation.

⁴³ (Hirschman 1970) famously labeled the options of members in organizations as 'exit', 'voice' and 'loyalty'.

Some of the foreign banks that acquired minority stakes in China's largest banks have been deeply involved in their restructuring process. Based on available evidence this has been the case more so for BofA at CCB and RBS at BOC, and to a lesser extent for Temasek at both CCB and BOC, than for others. This suggests that not every relation that was created by the initial transactions has produced more than financial returns for their investors. However, that is important information for the banks as well as for policy makers as they select partners for future transactions.

The best source for the nature and scope of collaboration that has taken place are the annual reports of the three banks, which are publicly available. While they give an incomplete picture and one written with the goal of pleasing investors in mind, they nonetheless contain important information. In its annual report for 2007 CCB acknowledges the contributions of Bank of America for the improvements in customer services: "In 2007, the Bank [CCB] rolled out retail branch transformation, one of the major strategic collaboration projects with BofA, across the Bank..." According to the report, 5,266 branches, or 39.16 percent of all branches, underwent transformation over the course of the year with positive impacts on sales volumes and work efficiency.⁴⁵ In addition, both BofA and Temasek were involved in developing different business areas for CCB. CCB and BofA established 32 "experience sharing projects", including a "voice of the customer project", which was used in the transformation of bank branches. Temasek provided training, among others, in small and medium-sized enterprise financial services and wealth management.⁴⁶ The collaboration with Bank of America in particular has gone well beyond consultancy and assistance with CCB's mainland transactions.

⁴⁴ See Sabel *supra* note 35 at 138.

⁴⁵ See CCB's annual report for 2007 available at www.ccb.com (under investor relations) at 16.

BofA merged its former subsidiary, BofA Asia in Hong Kong with CCB, thereby consolidating the banking operations of the two banks in Asia. Moreover, CCB and BofA jointly established CCB Financial Leasing, China's largest financial leasing company to date.⁴⁷

BOC's annual report for 2007 includes a separate section devoted to "cooperation with strategic investors".⁴⁸ The report highlights the cooperation between BOC and RBS in areas including "corporate banking, personal banking, financial market business, risk management and internal control, treasury and capital management, as well as human resource management."⁴⁹ Sixty of RBS senior managers worked with BOC's staff on these projects. Conversely, BOC seconded a senior manager to Citizens Bank in the US, a subsidiary of RBS, to observe banking operations there. The other two strategic investors, UBS and Temasek are less prominently featured in the report, although it mentions the establishment of a joint steering committee with UBS and Temasek's technical support for small and medium size business finance.⁵⁰

ICBC's annual report for 2007 contains information about the role of its major foreign strategic investors, Goldman Sachs, Allianz, and American Express.⁵¹ It suggests that Goldman was involved in investor relations, control compliance and risk management as well as treasury operations. In particular, Goldman Sachs is said to have "actively cooperated on the research and development of RMB interest rate derivative

⁴⁶ Ibid at 17.

⁴⁷ Ibid, 59-60.

⁴⁸ See BOC's annual report for 2007, available on BOC's webpage at <http://www.boc.cn/en/static/investor.html> at 96-98.

⁴⁹ Ibid at 96.

⁵⁰ Ibid.

⁵¹ See ICBC's annual report for 2007, available at <http://www.icbc-ltd.com/icbcltd/investor%20relations/download%20center/>

products, currency options products and foreign exchange structured products.”⁵² ICBC and the German insurance company Allianz cooperated on insurance business. They formed a joint venture (Allianz China) and Allianz assisted ICBC in developing sales concepts, and marketing networks. Finally, the strategic alliance with American Express materialized in the launching of several new credit cards in China.⁵³

All three banks received non-executive directors on their boards who concurrently occupied important positions at their parent organizations. BofA’s vice chairman of corporate development, Gregory Curl, served on the board of CCB. The Group Chief Executive of RBS, Fred Goodwin served on the board of BOC, and so did Lim Huat Peter Seah, also a member of Temasek’s advisory panel. Finally, Christopher Cole, chairman of the investment banking division at Goldman Sachs and John L. Thornton, a former president and director of Goldman Sachs served on the board of ICBC. Board seats occupied by minority shareholders may be less important for the ‘voice’ they confer than for the insights they offer about governance practices at the company they invest in. Given the dominant role played by government-controlled entities as major shareholders of these banks, they are likely to offer foreign investors clues not only about organizational governance, but also about the objectives for the governance of financial markets pursued by the Chinese authorities.

In sum, the foreign strategic investors in China’s three banks have been involved in developing areas of financial services in which they have a comparative advantage. China’s banks have been able to learn what were deemed some of the most important players in their respective field of expertise and to transpose what they have learnt into

⁵² Ibid at 92.

⁵³ Ibid.

the realities of China's financial market. Not all collaborations have been equally successful. That, however, does not defeat the strategy. To the contrary, engaging more than one strategic investor per bank helps diversify the risk associated with over-reliance on a single financial strategy that might turn out to be ill suited or simply flawed, but also against the risk of contagion or problems associated with the investor or its home market.

Learning by monitoring can also take the form of comparative monitoring by a central agent. By virtue of the fact that the government indirectly controls the Chinese intermediaries involved in these transactions Chinese authorities are in a position to compare the experiments these banks engaged. This puts them in a position to monitor the evolution of the relations and to assess their respective impact on domestic and global financial markets. This strategy of facilitating decentralized experimentation, monitoring the process of experimentation and its outcomes, and ultimately choosing from among them for wider application those with the most promising track record has been used extensively throughout China's economic reform process. The experiment with township village enterprises, which took different forms in different parts of the country, is a prominent example.⁵⁴ Some observers have attributed China's success in economic reforms in general to the organization of decision-making processes, which has encouraged decentralized experimentation and innovation under conditions of uncertainty. As Qian et al. (2006) explain, different organizational forms determine the success of innovation strategies. If the probability of success is high, because the strategy is well tested or sufficiently simple to generate sound predictions about outcomes, a centralized, a top-down reform strategy employing a "U-Form" is more effective. In contrast, under conditions of uncertainty, an organizational approach more akin to an "M-

Form” that encourages decentralized experiments is more likely to reap success over time.⁵⁵

Financial sector reform especially in the formerly socialist world is a complex undertaking with a low probability of success for any given strategy. The top down approach employed in Central and Eastern Europe as well as Latin America assumes the opposite. Based on the assumption that ‘best practice’ is knowable and universal, it prescribes a single model for organizing and governing financial markets. The application of this model to the real world has demonstrated not only that the same model may not work everywhere. The global financial crisis has also shed doubts on the merits of that model itself. Moreover, foreign bank dominance has left many banks in Eastern Europe and Latin America exposed to the success and failure of the banks’ parents whose conduct and business strategies they could neither monitor nor influence.

To be sure, the China-bank deals were also affected by the crisis. Several Western banks sold part or all of the shares they had acquired in Chinese banks upon the expiration of the lockup periods they had initially agreed to. This occurred primarily in the context of recapitalization efforts by these banks. Thus, RBS and UBS, two banks that had to be rescued by their home governments in the fall of 2008, sold their stake in Bank of China in early January 2009. Bank of America first increased its stake in China Construction Bank, taking advantage of an option to increase its shares to 19.9 percent at the end of the initial three-year investment period. However, subsequently the bank sold the nine percent stake it had originally acquired in response to pressure by the US

⁵⁴ (Jin and Qian 1997); see also (Qian 2003)

⁵⁵ (Qian, Roland, and Xu 2006)

government to shore up its capital base.⁵⁶ Finally, Goldman Sachs, Allianz, and American Express reduced their holdings in ICBC upon the expiration of their lockup period.⁵⁷

As suggested earlier, not all foreign investors were of equal value for Chinese banks in terms of promoting their transformation into major financial intermediaries. Thus, retaining BofA as an investor of CCB may have been more important than keeping UBS at BoC. Nonetheless, the fire sale by stricken investors was not part of the initial design of these transactions. In fact, the Chinese government recently announced that future investors in Chinese banks would have to agree to a four rather than a three-year lockup period.⁵⁸ It supports the notion that stability of bank holdings is high on the agenda of China's policy makers. As it turns out, engaging more than one foreign investor in China's bank at the time of privatization has contributed to that goal. Temasek, one of Singapore's two sovereign wealth funds, invested in CCB and BOC at the same time Western banks did. Not only did Temasek stay put as Western banks pulled out. It also acquired some of the shares they sold. Temasek participated in a consortium that bought CCB shares BofA sold in April 2009 and acquired a stake in ICBC by buying up shares Goldman Sachs and others sold in ICBC also in April 2009.⁵⁹ Moreover, it committed not to sell its stake in BoC at the moment. The vice-president of BoC even made a public statement that Temasek had a 'moral obligation' to contribute to market stability.⁶⁰ Whether the reasons for this moral obligation lies in Temasek's role as

⁵⁶ Some shares were sold in January, the remainder in May 2009. See Rick Carew and Costas Paris, "BofA gets US\$7.3 billion for CCB sale", The Wallstreet Journal 13 May 2009, available at www.wjsonline.com.

⁵⁷ Ross Sorkin, "American Express and Allianz Sell I.C.B.C. Shares", The New York Times, 28 April 2009, available at www.nytimes.com.

⁵⁸ The Economist, "China extends lockup period for foreign banks", 2 April 2009, available at www.economistonline.com

⁵⁹ Supra, note 56.

⁶⁰ See Jamil Anderlini, "ICBC secures Goldman pledge", The Financial Times 25 March 2009, available at www.ft.com.

foreign investors in all three banks or the fact that it is a SWF and as such is expected to share China's concern for the stability of financial markets more so than its private counterparts, is unclear. In any event, this episode should have re-enforced the notion that foreign investors do indeed come in different types and that they behave accordingly. By ensuring that each bank had at least two strategic investors the risk associated with each one of them was mitigated.

IV. Bank Deals in the Global Crisis

Learning by inter-organizational monitoring is a strategy not limited to the China bank-deals. In fact, it is a strategy frequently employed under conditions of uncertainty. Examples include collaborations among firms in high tech sectors where highly open-ended collaborative forms of contract are increasingly common.⁶¹ The same applies to the area of finance, as suggested by a series of recent transactions Western banks and sovereign wealth funds (SWFs). Back in 2005/06 Western banks queued for acquiring minority stakes in China's state controlled banks. Only two years later, Western banks found themselves queuing in China, Singapore, Kuwait and Qatar to sell stakes in their banks to 'Sovereign Wealth Funds' (SWFs)⁶² from these countries. The model used in the SWF transactions is strikingly similar to the transactional model of the China bank deals described above, and appears as their mirror image. They involved minority stakes often with two or even more SWFs, lockup periods or arrangements with similar effects, such

⁶¹ (Gilson, Sabel, and Scott 2009)

⁶² For a short definition of a sovereign wealth fund, see www.swfinstitute.org: "A Sovereign Wealth Fund (SWF) is a state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or

as the use of convertible instruments, and optional board seats for investors, yet no executive positions or control rights. Table 2 presents data on Western banks that have received capital injections from SWFs and/or other foreign individuals or entities.

INSERT TABLE 2 ABOUT HERE

One of the most striking features of these transactions is their durability. As discussed above, a number of Western banks have sold their stakes in Chinese banks when they needed to raise capital. In contrast, hardly any of the SWFs has dumped their stock in Western banks. To the contrary, many have deepened their ties despite of the financial losses they suffered. This is true for QIA's investments in Barclays, GIC's investments in Citigroup, as well as the investments by CIC in Blackstone and Morgan Stanley further discussed below. A partial exception is Temasek's sale of the stake in BofA. However, Temasek became a shareholder of BofA only as a result of that bank's merger with Merrill Lynch, in which Temasek had invested earlier.

Since the focus of this paper is the governance of financial relations in China, the following analysis focuses on the transactions that involved Chinese entities as investors in Western financial intermediaries. Consider first the transaction between Blackstone and China Investment Corporation (CIC) of May 2007. Blackstone is a US based asset manager with global reach. Until May 2007 it operated as a series of general partnerships, all separately owned by various Blackstone partners and all sharing the same "family" name. Total assets under management at the time of its reorganization were valued at

other financial instruments funded by foreign exchange assets." What distinguishes SWFs from other financial intermediaries thus is the dominant role foreign exchange assets play as the source of their capital.

US\$88 billion.⁶³ In May 2007 Blackstone was reorganized into a limited partnership structure so that the company could raise capital from outside investors without sharing control. Prior to Blackstone's public offering, 101,334,234 non-voting common units were sold at a discount of 5 percent to "an investment vehicle established by the People's Republic of China with respect to its foreign exchange reserves"⁶⁴ which later became a wholly owned subsidiary of CIC. This deal made CIC – China's newly formed sovereign wealth fund that manages US\$200 billion⁶⁵ -- the largest single investor in the newly formed Blackstone Holding. The limited partnership structure Blackstone chose for its reorganization did not grant voting rights to unit holders. Nonetheless, an investor with such a large stake and, even more importantly, additional assets available for future investments, is likely to be heard by any management irrespective of formal voting rights.

The detailed features of this deal are similar to those of the China-Bank deals discussed above. Future investments by CIC in Blackstone were restricted in the original agreement so that at no time it would own more than 10 percent equity in Blackstone Group LP.⁶⁶ CIC committed not to sell its units for a period of four years except in the event of a change of control at Blackstone. In the event that CIC decides to sell at the end of this lockup period it agreed not to sell more than 1/3 of its units in each of the following three years. Finally, in one of the clearest indications that the quid pro quo of the transaction went beyond the exchange of units for money, CIC "agree(d) to explore in good faith potential arrangements pursuant to which it or its affiliates would invest in or

⁶³ For details on Blackstone see the prospectus for its public offering of June 2007, available at <http://apps.shareholder.com/sec/>. [#5262437]

⁶⁴ Blackstone's prospectus supra note 23 at p. 1.

⁶⁵ For a detailed account on how CIC was established and capitalized, see (Martin 2008)

⁶⁶ Note, however, that this limit was raised to 12 percent in the fall of 2008. Gillian Wee, "Blackstone agrees to raise limit on China fund stake", Bloomberg at www.bloomberg.com

commit fund amounts to current and future investment funds managed by [Blackstone] and to evaluate in good faith and consider investing in any comparable funds or vehicles offered by [Blackstone] in connection with any investment they make in alternative funds or vehicles.”⁶⁷ The provision could be interpreted as a commitment device for Blackstone: Only if the deal turned out to be lucrative for CIC would they explore future business opportunities in ‘good faith’. CIC actually lost heavily on this transaction and has been severely criticized in China for it. Yet, because of the lockup provision CIC cannot walk away from the deal. In fact, CIC is unlikely to do so, as the benefits of partnering with Blackstone for future investment strategies not only in the US, but globally, may well pay off.⁶⁸

Within six months of the Blackstone transaction CIC made another important acquisition. In December of 2007 CIC acquired a 9 percent stake in the US investment bank Morgan Stanley. This time the investment took the form of convertible debt securities at a fixed interest rate of 9 percent. The change in deal structure came in response to the deepening global financial crisis and the losses CIC had suffered in Blackstone, and reflected the greater awareness of the risks of investing in financial intermediaries at this point in time. Even so, the revised structure of the deal had familiar features: CIC committed to a long-term engagement in Morgan Stanley. An early exit is unlikely, not because of an explicit lockup provision, but because of the structure of the deal. The use of convertible debt instruments binds the investor de facto until the conversion date, and likely beyond that date to a point in time when the conversion will generate a positive return. CIC’s choice to invest in Morgan Stanley rather than in

⁶⁷ See Blackstone’s prospectus supra note 23 at 5.

Citibank, Merrill Lynch, or other Western banks scrambling for capital at the time, reflects a preference for long-term partnerships with foreign investors. Morgan Stanley's foray into China's financial system dates back to the mid 1990s. As noted above, Morgan Stanley headed a consortium that acquired NPL from one of the major AMCs, which had been established to shore up the balance sheets of China's largest banks. In 1995 Morgan Stanley helped establish China International Capital Corporation, China's first international brokerage. Its joint venture partner at the time was China Construction Bank (CCB) – although CCB's shares in CICC were subsequently been transferred to CIC. Finally, Morgan Stanley acted as CCB's advisor on its IPO in 2005. CIC's investment in Morgan Stanley is a logical extension of this set of relations at a time when Morgan needed capital support. It gave CIC direct access to know how the operations of an internationally active investment bank. In fact, CIC asked Morgan Stanley in the spring of 2008 to develop an asset management plan for CIC's international investments.⁶⁹ CIC also stood ready to invest in Morgan Stanley in September 2008, when the investment bank faced collapse in the wake of the Lehmann Brothers bankruptcy – signaling its willingness to acquire another 40 percent in MS. However, it stepped aside when Mitsubishi UFJ of Japan offered a higher price for a 20 percent stake. CIC renewed its commitment to MS once more when it acquired additional shares in June of 2009, at a time when MS was trying to meet capital requirements that would allow it to pay back US government money it had received as part of the TARP program in October 2008.⁷⁰

⁶⁸ Shanggang Zhou, "CIC may hold Blackstone stakes for 5 to 7 years", in China Daily, 6 March 2008, available at www2.chinadaily.com.cn.

⁶⁹ Yan Pei, "Fierce competition to manage CIC assets", available at China.org.cn, July 1, 2008.

⁷⁰ Wang Xu, "CIC increases stake in Morgan Stanley", China Daily, 3 June 2009, available at <http://www.chinadaily.com.cn>.

The deal between China Development Bank (CDB) and Barclays differs from the other two transactions in that CDB appears only as a junior partner to Temasek, one of Singapore's two SWFs. CDB was established as a policy bank and was transformed into a commercial bank only in late 2008.⁷¹ At the time it invested in Barclays it had virtually no foreign experience. Co-investing with Temasek allowed CDB to learn first hand from one of the most successful SWFs in East Asia, and one that like CDB, whose history resembled those of a domestic development bank. In contrast, most SWFs operate as investment management firms. Temasek has become known for its role as a value investor, taking fairly large stakes in companies in critical sectors of the economy and selling them at a future date for profit.⁷² Over time Temasek's focus has shifted from heavy industry, to telecommunications, and finally to finance, as well as from domestic to international investments.⁷³ In the Barclays' deal, the two Asian financial intermediaries provided the UK bank with liquidity at the time Barclays was battling a competing bid for a merger with ABN-AMRO. Barclays eventually lost despite of the capital injection.⁷⁴ However, Singapore and CDB stayed on as shareholder despite the absence of any lock-in provisions. They subsequently participated in another public offering by Barclays in June of 2008, helping to boost the bank's capital base during the deepening financial crisis when private investors shied away from financial intermediaries. They also supported Barclays private placement of securities with an investment consortium led by

⁷¹ "China Development Bank to issue RMB 20 billion in bonds", China Knowledge, 14 October 2008, available at www.bloomberg.com.

⁷² For a comparison of Temasek's investment profile with that of other SWFs see (Monitor 2008)

⁷³ According to Temasek's most recent annual report, about 33 percent of investments are international. The report is available at www.temasekholdings.com

⁷⁴ With hindsight, this has turned out to be a blessing, as Royal Bank of Scotland and Fortis, two of the banks that participated in the hostile bid, which was ultimately successful depleted their capital base with this deal. See Mark Scan, "Fortis suffers ABN pain", 26 June 2008, available at www.forbes.com.

Qatar in November of 2008 as a means to fend off UK government ownership in the bank.⁷⁵

In sum, just as the China bank deals, the SWF transactions were structured to create commitments for the parties involved beyond the quid pro quo of a standard portfolio transaction. This does not mean that CIC, CDB, or Temasek were uninterested in harnessing returns on their investments. However, the financial loss may have been compensated at least in part by opportunities to learn about how their targets or co-investors operate.

IV. Concluding Comments

China has established an approach to banking or, more broadly, financial sector reform that differs markedly from those used in other emerging market economies. At the core of this approach has been the creation of equity ties between a large Chinese bank and two or more strategic investors from different governance regimes. Instead of transferring control, these transactions enabled cooperation and inter-organizational learning. The approach for financial sector reform reflects a broader trend in China's economic reform strategy -- one that emphasizes the continuous process of economic transformation and the need for the continuous adaptation and experimentation of institutional arrangements under conditions of uncertainty.

⁷⁵ The transaction, which was roundly criticized by most other shareholders, will give the Qatar consortium of stake of about 33 percent in Barclays. For details of the plan see Letter by Marcus Agius, Chairman Barclays PLC, to shareholders accompanying the notice of the General Meeting of Barclays on 24 November 2008, available at www.investorrelations.barclays.co.uk. For a detailed discussion of this transaction see also (Pistor 2009).

The transactions between Western banks and SWF from China, Singapore and the Middle East concluded during the global financial crisis bear striking similarities with these earlier transactions. Just as in China's bank deals, investors acquired only minority stakes, not control rights. In most cases more than one investor was involved, and most agreed to lockup periods or structured the transactions to make an early exit difficult. An important motive for these deal structures was to stabilize ownership patterns as a means for reducing share price volatility on one hand, and the ability to learn from monitoring and cooperating with other parties. This deal structure marks a departure from patterns of foreign investments that assume superior expertise by one party and that uses control rights as a surety for transferring such expertise.

The global financial crisis has cut short some of these relations – most notably in the case of RBS and BoC. It has also subjected the transactional models discussed to a stress test. This revealed that minority owners, even those holding a fairly large stake, might not be the stable owners they were expected to be. As long as the cost of exit is not prohibitively high, they will exit when it suits their needs. The most effective insurance against the downward pressure such an exit can exert on share prices and, by implication on the stability of domestic banks has been the presence of another strategic investor who was willing and able to step into the void. As it turns out, SWFs have been more reliable stabilizers than private investors.⁷⁶ This suggests that the identity of the owners may be as important as the structure of the deal. It remains to be seen whether SWFs' willingness to

⁷⁶ This applies not only to the comparison between Temasek and RBS, UBS, or BofA in the case of Chinese banks, but also to the comparison between Qatar Investment Authority and Sheikh Mansour of Abu Dhabi in the case of Barclays. Whereas QIA appears to be operating as a long term shareholder of Barclays, Sheikh Mansour sold a large stake in Barclays even prior to the set conversion date. See Andrew England and Simeon Kerr, "Man in the News: Sheikh Mansour", The Financial Times, 5 June 2009, available at www.ft.com.

endure financial loss in the medium term will pay off in the long term. One thing seems to be sure, however: for recipients of foreign investments, limiting the stakes of individual foreign investors and diversifying among them may limit the fallout from crisis that originate in the parent company or its home country.⁷⁷ Moreover, it offers recipients of investments an opportunity to diversify among different business models and financial strategies, thus increasing the pay-off from inter-organizational learning.

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⁷⁷ See also De Haas and Van Lelyveld (2008).

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Table 1: Foreign Investors & China's Largest Banks

Bank	Foreign Investor	Stake	Other Blockholders	Stake
Bank of China	Royal Bank of Scotland	8.25	Hui Jin	59.12
	UBS	1.33	Jianyin (WOS of Hui Jin)	8.85
	Temasek (Fullerton Fin)	4.13		
China Construction Bank	Bank of America	8.19	Hui Jin	67.49
Industrial and Commercial Bank of China	Temasek (Fullerton Fin.)	5.65	Ministry of Finance	35.5
	Goldman Sachs	4.19		
	Allianz	1.9	Hui Jin	35.3
	American Express	0.4		

Source: Compiled by author from various annual reports of BOC, CCB and ICBC available from their web pages.

Table 2: SWF Investments in Major Western Banks

Bank	SWF 1*	SWF 2*	SWF 3*	Other*
Blackstone	CIC (9.9) (2)			
Barclays	QIA (6.42) (12)	Temasek (2.6)	CDB (3)	Sheikh Mansour (16)
Merill Lynch	Temasek (4.4)	KIA (2)	KIC (2)	
Morgan Stanley	CIC (9) (2)			Mitsubishi UFJ (20)
UBS	GIC (9.7)			Saudi Arabian investor (2)

Note: The size of the stake acquired in a single transaction is in parenthesis. CIC = China Investment Corporation; QIA = Qatar Investment Authority; CDB = China Development Bank; KIA = Kuwait Investment Authority; KIC = Korean Investment Corporation.

Source: Various news reports compiled by the author.