EUROMONEY

What future for foreign stakes in China's banks?

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Three key questions arise from the recent sale of stakes in Chinese banks by their global counterparts, two of them widely asked, one not. Observers are wondering what the impact will be on global banks' relations with China, and what will happen when the lock-ups on foreign bank stakes in ICBC expire in April. Rather fewer are asking if, irrespective of the global lenders' capital positions, this is anyway a good time to be bailing out of Chinese banks.

Did political pressure force Ken Lewis to pull CCB state sale?

As soon as Bank of America shelved a deal to shift some of its stake in China Construction Bank in December, many observers leapt to a swift conclusion: China had nixed the deal because it didn't like the idea of the sale, or the timing. It is understood that Bank of America chairman and chief executive Ken Lewis pulled the sale after speaking with his opposite number at CCB, Guo Shuqing, but state pressure is unlikely to be the full story, as subsequent events have demonstrated. It appears that at least part of the reason was a technical and legal issue springing from the fact that Bank of America's stake had been amassed in two different purchases with different lock-up periods, and it was unclear what rules on allocation of profits would apply to the mooted sale; the fact that the sale did go through less than a month later supports the view that it was a technical delay rather than a veto. Subsequent sales of Bank of China stakes by UBS and Royal Bank of Scotland also undermine the view that China has tried to block sales.

That's not to say, though, that sales are being handled with anything other than almost paranoid sensitivity. "No foreign bank would sell a single share in a Chinese bank without going through a very rigorous process of consultation with the bank and the Chinese government," says a banker at a global firm with links to a Chinese institution. "I think the Chinese government is realistic and understands that some of these institutions have liquidity problems. But they also recognize the fact that a wholesale retreat from the banking sector in China is not in the interest of China, and they would be justified in discouraging it."

The selling banks' situations have been different: UBS's sale of its 1.33% stake in Bank of China for $835 million is not considered problematic since that deal was always seen as a financial rather than strategic investment, and in some measure part of a pitch to get an advisory mandate on Bank of China's Hong Kong IPO in June 2006. (Besides, UBS already has its precious licence to operate in China's domestic capital markets.) Since Bank of America's sale was only a trimming of its 20% holding in CCB, that leaves Royal Bank of Scotland, which shifted its entire 4.3% stake in Bank of China in January, as the one that might look most vulnerable to state ire. However, with RBS having since moved to 68% ownership by the UK state, it is surely plain to China that the bank's management is operating under extraordinary circumstances.

China has been fickle before, though. "If you go back far enough and take incidents where certain banks have offended China and then look at the league tables for the next three years, you can see they get excluded," says a banker. Citi is generally considered the classic example here, following its handling of the CNOOC privatization in 1999. He continues: "China is still a centrally managed economy. That doesn't necessarily mean every civil servant you come across has the same point of view but it does often mean the left hand has some connection to what the right hand is doing." Phil Groves, founder and president of DAC Management, the largest buyer of non-performing loans in China and with years of close relationships with the country's banks, adds: "I can't imagine why anyone in Beijing would be happy with foreign banks making money selling PRC bank stocks while the CIC lost money on US banks and fund investments."

The assumption seems to have been that banks have been forced into the sales to shore up capital positions. However, what if they view this as the best time to get out of Chinese banks regardless? Chinese bank stocks have fallen dramatically from their peaks, and some think there's worse to come. "If their holdings in Chinese bank shares were seen as a sure winner in the near term, they wouldn't have sold," argues Victor Shih, assistant professor at Northwestern University in Illinois and a noted scholar of Chinese banking. "It reflects increasing doubt by the outside world of the performance of Chinese banks in the near term. The government is putting enormous pressure on these banks to lend not just to the main stimulus package [in China] but the local packages too." He expects non-performing loans to increase by at least Rmb800 billion ($117 billion) in 2009. "The reality of Chinese banks is that they are still fundamentally controlled by the government."

Tjun Tang, partner and managing director at Boston Consulting Group in Hong Kong, is not quite so bearish. "We don't think we're going to see the same level of problems we've seen in the international banking system," he says.

All eyes are now on ICBC, where lock-ups on stakes held by Goldman Sachs, Allianz and American Express expire in April and October. Goldman's presence in particular will be interesting here: it wears two hats in its stakeholding, one as a strategic partner (it is actively involved in training and cooperation in ICBC) and one as a private equity investor, including funds managed for other investors.

And what of the future? Will foreigners still be welcome to come back in to Chinese banks? "There is a role for the foreign strategic investors, and they have played that role very well, but we are now in a new era," says Tang. "There has to be some commercial logic as to why you would want a strategic investor to come in again, and if you are one of the big banks, it's not immediately obvious what that rationale would be."