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INTERNATIONAL FINANCIAL LAW REVIEW

US-China trade wars part two: banking regulations

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Regulations are impacting deal flow between the US and China as much, if not more, as imposed tariffs. The landscape is very unusual. On the US side is the beefed up multi-agency-led Committee on Foreign Investment in the United States (Cfius), which is throttling Chinese investment into the US. Cfius will be the focus of chapter three of this series.

On the other hand, however, the Chinese government is implementing a number of regulatory reforms designed to attract foreign investment, including from the US. A strange paradox.

Part one of this series, which looks at tariffs, can be found here.

Trade friction obviously has an impact on cross-border activities, but when it comes to China, it is important to not focus too narrowly and just look at M&A and initial public offerings. "If you look at it holistically there are risks and opportunities," said Lu Cao, executive director of corporate and investment banking at

JPMorgan, whose clients are largely north American subsidiaries of multinational corporations from China.

When JPMorgan looks at a Chinese company looking to expand – not necessarily in the form of a listing per se, it could be eying public investment at state or national level, for instance – it monitors how the company interacts with the various states in the US, and how it views opportunities outside of China.

"Those companies' strategies will change as the environment changes. At the end of the day there are two things that are clear: firstly, that Chinese companies want to go out and explore the world," she said. "The second is that Chinese regulators and the government are committed to opening up the financial markets, which gives us the confidence that we can continue to work in China and to explore the opportunities that Chinese corporates offer."

Open doors?

Until recently, the Chinese government prevented foreign ownership of a majority stake in any company. A recent law has changed this. As laid out by Jason Yang, head of corporate and institution coverage for the Americas at ICBC Standard Securities, the largest bank in China, the country and the bank are trying to encourage US clients to enter. "We all know the Chinese economy has slowed, and that confidence between the US and China over the last two years has also slowed down," he said.

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"But, to add one very important signal that everybody in the banking industry should pay attention to. The Chinese regulator reduced the limitation of the shareholder of the bank institution in China, which means US [and other jurisdictions] banks, insurance companies, security firms, or others, can hold a majority shareholding in China to acquire majority shares of that institution under a new entity."

This means they can fully control Chinese entities.

The move was announced by China's State Council, which is headed by Premier Li Keqiang. The rules also mean that foreign insurance companies no longer need to have been active in the industry for 30 years, or have had two years of representation, as was previously the case.

According to Harry Broadman, emerging markets practice chair at Berkeley Research Group and former member of Cfius, these regulations are positive, if enforced. Both in terms of how local

banks and US branches are expressly permitted to coexist: because the minimum asset requirements have been lowered, and because the number of sectors that banks and insurance companies can act in has been broadened. "What has happened in terms of the administrative regulations issued by the Chinese in October is positive and market-forward. That is, if they are enforced and abided by, which – particularly in China – is always an issue," he said.

"If you look at these banking regulations relative to the new foreign investment law, they're much more concrete. They are quite forward and market-leaning in terms of liberalisation," he said.

"It signals to me that the policymakers and regulators in China realise that in order to continue to grow they need other sources of financing from the outside world, not just state-owned banks or the smaller domestic banks in China," he added. "It is a helpful change in policy, if it is enforced."

In addition, China's State Administration of Foreign Exchanges (SAFE) has introduced new draft measures that will allow foreign institutional investors to participate in interbank FX derivatives and to manage foreign exchange risk arising from interbank bond investments.

JPMorgan won approval earlier this year to acquire a majority stake in a securities company in China, and is in the process of hiring, setting up a platform and building up a franchise. "We already have a majority-owned bank, and now we have a majority-owned security company as well," said Lu Cao. "We also won the auction to own the majority of an asset management firm, so we have that whole spectrum of solutions that we can provide to the client," she added. Of course, JPMorgan, being one of the biggest investment banks in the world, is an exception and entering the market is far harder for smaller firms.

Slowed, not stopped

The domestic Chinese market remains highly attractive to international investors. The country is in the process of transforming itself from an investment-led to a consumption-driven economy. Regulators and the government are also contributing, with initiatives like the bond and stock connect programmes.

"China has the third-largest stock and bond market in the world – it's hard for us to ignore that. The local market is very significant for an institution to be successful," said Lu Cao.

According to a partner at a US private equity firm, while bigger financial services companies may view a presence in China as a necessity, he's not convinced the same applies for smaller operations. "The marketplace is too big to avoid for many: Goldman Sachs, Citigroup, Fidelity, they have to be in China," he said.

"We don't necessarily. With the size of businesses we are investing in, some will find the Chinese market to be useful, but generally it's not. We don't invest a lot in Asian-headquartered businesses, for us it would be more likely to be based in Europe or New York trying to find customers in China."

Internally, China is going through significant, structural economic changes, and as it works through that process there will be ups and downs. Regulators are working to ensure that the country and its financial system progresses as smoothly as possible through that journey.

What banks need to know

"In any economy there is downside risk at some point. The key to doing business with China, or in China, or investing in China, or anything related to China, is to know yourself really well," said Lu Cao.

This is because firms have to think about both long and short-term strategies, and about risk tolerance and exposure. The second step is knowing the target market well enough to execute, because "you cannot just move everything you think is good about your own market to a new market".

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"Before you formulate a China strategy you need to have a deep understanding of the market and of the clients that you want to focus on," added Yang. "Do you want to just focus on close-up clients, or do you want to go into the retail market?"

At present, ICBC is close to monopolising the retail market. Banks need to consider if they actually want to compete with such a sizable competitor, and have to consider their timing carefully.

From a banking perspective, China is making its move on to the world stage, while also strengthening commitment internally. If foreign banks are to win Chinese clients over, it's imperative they confidently show their ability and how they intend to operate in the market.

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