



# Extended Annual Review Report

---

Reference Number: 30704  
April 2009

## Equity Investment People's Republic of China: China Everbright Bank

In accordance with ADB's public communications policy (PCP, 2005), this extended annual review report excludes information referred to in paragraph 126 of the PCP.

Asian Development Bank

## CURRENCY EQUIVALENTS

Currency Unit – yuan (CNY)

		<b>At Appraisal</b>	<b>At Project Completion</b>
		14 September 1996	13 December 2007
CNY1.00	=	\$0.1204	\$0.1355
\$1.00	=	CNY8.3052	CNY7.3785

## ABBREVIATIONS

ADB	–	Asian Development Bank
BOC	–	Bank of China
CAGR	–	compound annual growth rate
CAR	–	capital adequacy ratio
CBRC	–	China Banking Regulatory Commission
CCB	–	city commercial bank
CEB	–	China Everbright Bank
CEG	–	China Everbright Group
CIB	–	China Investment Bank
EROIC	–	economic return on invested capital
FIRR	–	financial internal rate of return
GDP	–	gross domestic product
ICBC	–	Industrial and Commercial Bank of China
IFC	–	International Finance Corporation
IFRS	–	International Financial Reporting Standard
IPO	–	initial public offering
NAV	–	net asset value
NPL	–	nonperforming loan
PBOC	–	People's Bank of China
PRC	–	People's Republic of China
PSOD	–	Private Sector Operations Department
RCC	–	rural credit cooperative
ROIC	–	return on invested capital
SME	–	small and medium-sized enterprises
SOCB	–	state-owned commercial bank
SOE	–	state-owned enterprise
TA	–	technical assistance
WACC	–	weighted average cost of capital

## NOTE

In this report, "\$" refers to US dollars

<b>Vice-President</b>	X. Zhao, Operations Group 1
<b>Director General</b>	P. Erquiaga, Private Sector Operations Department (PSOD)
<b>Director</b>	R. van Zwieten, Capital Markets and Financial Sector Division, PSOD
<b>Team leader</b>	M. E. Paterno, Investment Specialist, PSOD
<b>Team members</b>	B. Huang, Young Professional, PSOD I. Chua, Investment Officer, PSOD



## CONTENTS

	<b>Page</b>
EXECUTIVE SUMMARY	i
I. THE PROJECT	1
A. Project Background	1
B. Key Project Features	2
C. Progress Highlights	2
II. EVALUATION	3
A. Project Rationale and Objectives	3
B. Development Impact	4
C. ADB Investment Profitability	8
D. ADB Work Quality	9
E. ADB's Additionality	10
F. Overall Evaluation	11
III. LESSONS AND RECOMMENDATIONS	11
APPENDICES	
1. Foreign Investments in Mainland PRC Banks	13
2. Overview of the People's Republic of China's Banking Sector	16
3. Private Sector Development Indicators and Ratings: Financial Intermediaries	21



## EXECUTIVE SUMMARY

In October 1996, the Board of Directors of the Asian Development Bank (ADB) approved a \$20 million direct equity investment in China Everbright Bank (CEB or the Bank) through its private sector operations. ADB also approved a \$60 million loan under the public sector operations to the Government of the People's Republic of China (PRC), the proceeds of which were lent to CEB. The main objective of the Project was to assist CEB in becoming a model commercial bank following best practice principles, and to expedite the further liberalization of the financial sector as ADB's investment was the first foreign equity investment in a domestic commercial bank. The Project was also the first public and private sector hybrid assistance undertaken by ADB in the PRC.

The equity investment in CEB was evaluated using criteria defined in ADB's *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations* (2007). The investment was evaluated against four criteria: (i) development impact, (ii) ADB investment profitability, (iii) ADB's work quality, and (iv) ADB's additionality. On this basis, the overall rating of the Project is "satisfactory".

The development impact of ADB's equity investment in CEB is rated "satisfactory". The overall development impact was evaluated against four criteria: (i) private sector development, (ii) business success, (iii) economic development, and (iv) environment and social performance. With regard to private sector development, the Project was a pioneering investment that had catalytic effects on future foreign investment in domestic PRC banks. The Bank's ownership diversification and commercialization, in turn, had a positive impact on the development of the financial sector as well as other private enterprises including small and medium-sized enterprises. The private sector development impact is rated "satisfactory".

Although CEB has grown rapidly in terms of assets and market reach, it suffered from excessive exposure to related parties, insufficient loan loss provisioning, and weak capitalization over the term of ADB's investment in the Bank. Its financial performance was also hampered by legacy issues, particularly from its takeover of China Investment Bank (CIB) in 1999. The assumption of CIB's deeply impaired loan portfolio and all of its liabilities weakened CEB's financial condition considerably, and consumed considerable financial and management resources. CEB was operating effectively with negative equity from 2004 until it received a CNY20 billion capital injection from the Government and settled the issue of related party transactions amounting to CNY5.2 billion in November 2007. The calculated return on invested capital in 2007 when ADB exited was higher than the weighted average cost of capital. Taking into account the exit year return on invested capital and the Bank's overall business performance, business success is rated "partly satisfactory".

The economic return on invested capital in 2007 was greater than 20%, thus, the Project's contribution to economic development is rated "excellent". The Project was environmental category C as it was considered unlikely to have significant environment impacts. At the time of project approval, the FI<sup>1</sup> category for credit lines through a financial intermediary or equity investments in a financial intermediary had not yet been created, and ADB did not require categorization for social safeguards. CEB was thus not required to implement an environmental management system. However, CEB's credit policies clearly stipulate that no

---

<sup>1</sup> Projects involving a credit line through a financial intermediary or an equity investment in a financial intermediary are categorized as FI.

credit should be provided to projects that violate state laws, regulations, and policies. On this basis, the Project was not rated based on environment and social performance.

Regarding investment profitability, the financial internal rate of return (FIRR) was 7.2%. On project approval, a minimum 7.0% FIRR was calculated under the adverse case whereby ADB would exercise its put option because of non-listing of CEB's shares. The realized FIRR of 7.2% exceeds the minimum return requirements defined at approval by the multiples of 0.9 (but lower than the multiple of 1.3), yielding a "satisfactory" rating.

ADB's work quality is rated "satisfactory" based on the following three criteria: (i) screening, appraisal, and structuring of the Project; (ii) monitoring and supervision; and (iii) ADB's role and contribution. Regarding the first criteria, ADB's performance is rated "excellent". The Project was the first public and private hybrid project carried out by ADB in the PRC and it addressed the reform and development needs at both government and company levels. The equity investment component was also well structured, as it included a put option that became instrumental in protecting ADB's investment. ADB's performance related to supervision and administration is rated "satisfactory". The Private Sector Operations Department closely monitored CEB's performance through regular reviews and ADB staff were proactive in utilizing the put option to protect ADB's interest. Monitoring and supervision through ADB-appointed board members was also broadly effective. Through ADB's investment and active representation in the CEB board, coupled with the provision of technical assistance, ADB was highly instrumental in pushing for improvements in CEB's corporate governance and the upgrading of its operations and management which, in turn, contributed to the strengthening and commercialization of PRC banks. This was consistent with ADB's country operations strategy for the PRC at the time of approval, which emphasized assistance to financial institutions that had the potential to be key change agents in the liberalizing economic environment. ADB's role and contribution are therefore rated "satisfactory".

ADB's additionality is rated "excellent, as ADB's equity investment helped accelerate reform of the PRC's financial sector by opening up the banking sector to foreign direct investment.

The main lessons drawn from ADB's investment in CEB are the following: (i) put option as a mechanism to protect ADB's investment; (ii) limitations on ADB's role as a minority investor; (iii) value of technical assistance alongside a direct equity investment; (iv) need for better project information maintenance by ADB; and (v) increased collaboration between ADB's public and private sector operations, whenever feasible and practical.

## I. THE PROJECT

### A. Project Background

1. In October 1996, the Asian Development Bank (ADB) approved an equity investment of \$20 million in local currency equivalent in China Everbright Bank (CEB or the Bank) of the People's Republic of China (PRC). The investment aimed to support the transformation of CEB into a model commercial bank, and further liberalization of the financial sector by making the first foreign equity investment in a domestic commercial bank.

2. In 1979, the PRC began restructuring its financial sector as part of the overall economic reform program. The mono-banking system was replaced by establishing four specialized banking institutions<sup>2</sup> and the People's Bank of China (PBOC) as the country's central bank in 1983. Under this two-tiered banking structure in a planned economy, competition in the financial sector was virtually nonexistent, and no distinction was made between policy and commercial lending. Increased financial liberalization continued in the 1980s, which led to increased banking competition and diversification of financial instruments for investment funding. The business scope of the four specialized banks began to overlap, new national and regional commercial banks were established, and more nonbank financial institutions emerged. However, in the early 1990s, the underlying weaknesses of the financial systems—lack of indirect instruments of monetary control, weak legal and regulatory framework and surveillance systems, misuse of interbank lending for property development and stock market speculation, and mounting debts and losses of many state-owned enterprises (SOEs)—were exposed.

3. The financial setbacks in the early 1990s offered valuable lessons and set the stage for the Government to deepen financial reforms in tandem with fiscal and enterprise reform. The passage of the Commercial Banking Law encouraged increased competition by heralding the entry of new banks and opening up the sector to foreign financial institutions. Under the law, domestic banks were also expected to adopt modern and self-regulatory commercial banking practices.

4. In January 1996, the Government requested from ADB a \$60 million line of credit for CEB to augment its long-term foreign currency resources and to strengthen the Bank institutionally. Established in August 1992 as a national commercial bank by the China Everbright Group Ltd (CEG),<sup>3</sup> CEB was selected over other newer nationwide commercial banks on the basis of its past performance and likelihood to succeed, to serve as a model for other commercial banks to emulate. CEB was also undergoing a capital restructuring and ADB was invited to participate through an equity investment. Despite the strict rules governing the rights of foreign financial institutions with equity stakes in local commercial banks at the time, ADB considered that an equity investment in CEB in addition to the loan would significantly expedite the reform process.

5. CEB completed its joint-stock reform on 15 January 1997, becoming the first nationwide joint-stock commercial bank with an international financial institution as shareholder. The investment in CEB represented a landmark transaction as the first foreign investment in a local commercial bank in the PRC, further liberalizing the investment environment of the financial sector and leading the way for similar transactions in the future. Appendix 4 provides an overview of CEB.

---

<sup>2</sup> These included the (i) Agricultural Bank of China for rural banking; (ii) Bank of China for foreign exchange transactions and international trade; (iii) Industrial and Commercial Bank of China for urban commercial banking, especially for industrial technical renovation projects; and (iv) China Construction Bank for large-scale new construction projects.

<sup>3</sup> CEG is a wholly state-owned investment conglomerate controlled by the State Council, the highest executive body of the Government.

## **B. Key Project Features**

6. The Project was the first joint public and private sector assistance package provided by ADB in the PRC. Through the public sector window, ADB provided (i) a \$60 million loan to the Government for onlending to CEB to support projects in various sectors; and (ii) technical assistance (TA) of \$600,000 to CEB for institutional capacity building.<sup>4</sup> The aim of the TA was to develop and strengthen CEB's capacity to operate as a full-service universal commercial bank and to adopt international commercial best practices through the improvement of CEB's credit policy and risk management practices, and staff training. Through its private sector operations, ADB subscribed to 92,222,000 common shares of CEB at CNY1.80 per share for a total investment of CNY165.9 million (\$20.0 million), representing 3.3% of CEB's issued share capital.

7. The Shareholder's Agreement between ADB, CEG, and CEB executed in November 1996 provided ADB with a put option on CEB exercisable to CEG for a 7-year period ending 31 December 2003 (put option). The exercise price was set at the higher of (i) an amount equivalent to the price paid for each share in a most recent transaction taking place within the 6-month period immediately preceding the date of the put notice involving a sale of not less than 1% of the shares by CEG, or (ii) the net asset value (NAV) per share calculated from the audited accounts of CEB for the most recent fiscal year plus a 33.3% percentage premium (equivalent to the percentage premium paid by ADB over the NAV per share at the time of the initial closing).

## **C. Progress Highlights**

8. At the insistence of regulators and as part of its strategy of rapid growth in March 1999, CEB acquired another medium-sized commercial bank, China Investment Bank (CIB). The acquisition resulted in the immediate doubling of CEB's operational capabilities through the branch licenses previously held by CIB. CEB benefited from an increase in its domestic market share through synergy and access to CIB's large customer deposit base. However, the acquisition caused financial problems as well since CEB assumed the bulk of the liabilities and nonperforming assets of CIB.

9. To raise its CAR significantly above the legal minimum as well as enable its planned initial public offering (IPO) and support its rapidly expanding lending portfolio, in 2000, CEB issued to its existing shareholders the rights to subscribe to 4.27 additional shares for every 10 shares held. ADB did not subscribe to the additional shares, which were taken up by other investors. ADB's decision not to participate in the rights offering reduced its shareholding from 3.3% at the time of the original investment to below 1.9%.

10. In 2002, CEB provisioned for CNY8.6 billion worth of NPLs carried over from the CIB acquisition. The provisions reflected management's determination to clean up the balance sheet and was a positive move in resolving CEB's under-provisioning. However, this reduced NAV and brought down CAR significantly. ADB took steps to protect its economic interest and renegotiated the put option to include a fixed minimum price. On December 2004, a second amendment to the Shareholders Agreement was executed with the provision that ADB's put option price would, in no event, be less than CNY1.60.

11. By the end of 2005, CEB still had not released its 2004 annual report—apparently because auditors could not issue an unqualified audit opinion and were not willing to recognize CEB as a going concern. CEB's financial position had deteriorated such that it was operating with negative

---

<sup>4</sup> ADB. 2006. *Technical Assistance to the People's Republic of China for Capacity Building of Everbright Bank of China*. Manila (TA 2658-PRC).

equity. In December 2005, a third amendment to the Shareholders Agreement was executed extending ADB's put option period once again until 31 December 2007.

12. In August 2007, the Government approved a reform and restructuring plan for CEB. Under the proposed restructuring plan, all shareholders were to recognize a loss through the reduction of the number of shares. In September 2007, ADB sent a notice to CEB informing the Bank of its intention to exercise the put option.

13. In November 2007, CEB received a \$2.7 billion (CNY20.0 billion) capital injection from the state through China SAFE Investment Limited (Huijin),<sup>5</sup> the first time the central Government has injected state funds in a second-tier bank. All of CEB's legacy-related party transactions estimated at CNY5.2 billion were also settled completely. The capital injection from the Government was the first step in CEB's restructuring and reform, and paves the way for CEB to sell a stake to overseas strategic investors and a proposed listing thereafter.

14. In December 2007, in accordance with the Shareholders' Agreement, CEG purchased the entire shareholding of ADB in CEB. As a result of the restructuring, CEB's CAR improved to 7.19% by the end of 2007 from -0.39% the previous year. In February 2008, CEB's individual rating was upgraded by Fitch to D/E from E, reflecting the Bank's improved financial profile, bolstered by Huijin's capital injection, as well as its improved asset quality. The Fitch Support Rating was also upgraded to 2 from 3 reflecting CEB's new ownership structure, in which the Government via Huijin is the largest shareholder with a 70.88% stake, as well as the Government's track record supporting CEB. CEB's financial position continued to improve in 2008 after the issuance of CNY8.0 billion in subordinated debt and the sale of nonperforming assets amounting to CNY14 billion to three state asset management companies.

## II. EVALUATION

### A. Project Rationale and Objectives

15. The investment in CEB is evaluated using criteria defined in ADB's *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations*<sup>6</sup> (the Guidelines). The four criteria are (i) development impact, (ii) ADB investment profitability, (iii) ADB work quality, and (iv) ADB additionality.

16. The ADB investment was a direct response to the Government's request for assistance in the liberalization and commercialization of the PRC banking sector. The Government's agenda for deepening financial sector reforms provided for the pursuit of increased competition in the sector, not only through the entry of new banks, but the further opening up of the sector to foreign financial institutions. Domestic banks were expected to adopt modern and self-regulatory commercial banking practice. ADB's investment was anticipated to ultimately contribute to this goal by: (i) facilitating the diversification of ownership of the PRC's domestic commercial banks, and (ii) assisting in the transformation of CEB into a model commercial bank following international best practice principles. ADB's investment was also consistent with, and complemented, ADB's work in the PRC's financial sector which aimed to encourage the commercialization of banks through the adoption of modern banking practices.

---

<sup>5</sup> Huijin is a wholly state-owned investment company. As a state-authorized institution and on behalf of the state, Huijin implements the equity investment and consolidation in state-owned key financial enterprises, and performs the rights and obligations as an investor. Huijin does not engage in any other business activities, nor does it interfere in the daily business operation of state-owned key financial enterprises in which it has a controlling share.

<sup>6</sup> ADB 2007. *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations*. Manila

## **B. Development Impact**

17. Development impact is rated “satisfactory”, evaluated under the following subheadings: (i) private sector development, (ii) business success, (iii) economic sustainability, and (iv) environment and social performance.

### **1. Private Sector Development**

18. The overall contribution of the Project to private sector development is rated “satisfactory”. The Project was a pioneering investment that facilitated future foreign investment in domestic banks. In turn, the Bank’s ownership diversification and commercialization had a positive impact on financial sector development as well as on private enterprises including small and medium-sized enterprises (SME). The individual indicators are assessed in detail in the private sector development checklist in Appendix 3.

#### **a. Direct Company Impact**

19. ADB’s primary objective for investing in CEB was to help it grow and develop into a model commercial bank. At the time of investment, CEB had a network of 7 branches and 2 subbranches. The Bank has grown considerably since then and now operates 30 branches, more than 400 operating outlets, over 580 self-service banking outlets, and 2,580 ATM terminals in 41 cities in 23 provinces, autonomous regions, and municipalities in the PRC.

20. Over the years, CEB has been quite successful in developing new products and services such as electronic banking, renminbi and US dollar charge cards, and custody operations. It was also the pioneer in introducing same day settlement for interbranch customer transactions. Recent innovations have been made in terms of service methods, channels, and models. For instance, CEB was the first PRC bank to offer a fixed rate housing mortgage product. In its corporate banking operations, it has also developed more than 20 service models, including refund guarantees, bill buyout, merchant warehousing, and agency discounting to service upstream and downstream enterprises in an industrial chain.

21. ADB has been represented in CEB’s board of directors since its investment in 1997. Through ADB’s active participation on the board, CEB has made some progress in improving corporate governance. ADB provided extensive research materials and suggestions for the enhancement of corporate governance: (i) the revision of CEB’s Articles of Association, including a section on independent directors; and (ii) drafting of terms of reference for various board committees. In fact, CEB became the first domestic bank to introduce independent director(s) to the board. ADB introduced a highly capable candidate for the vacant independent director position, which, after a series of discussion and negotiations, was accepted by the board and shareholders. In addition, new credit policies were adopted, improved personnel and remuneration policies were adopted, changes in organization structure were effected, and IT investments were encouraged. In 2003, ADB engaged CEB’s management in discussions in the key area of NPL disposal, SME lending, mortgage lending, and insurance.

22. ADB’s investment was also intended to set the stage for similar investments by other potential foreign investors. It was envisaged that, with the adoption of best practices in risk and liquidity management, coupled with access to long-term funds for onlending (through the ADB public sector loan), CEB would prepare itself for credit rating by an international credit rating agency. The inputs of ADB’s capacity building TA facilitated CEB’s adoption of best practices in risk and liquidity management and CEB applied for and was rated by Moody’s in 2000.

23. However, there were also limitations to ADB's role as a minority stakeholder. Despite ADB's efforts to introduce improved corporate governance and bring substantial change through its seat on the board, it was often overruled by other directors representing CEG, the controlling shareholder, as well as other SOEs. Thus, the overall pace of CEG's adoption of international banking best practices and high standards in corporate governance was slower than expected.

#### **b. Beyond Company Impact**

24. ADB's investment in CEB was considered a pioneering project for opening the doors of the domestic commercial banking sector to foreign investment. This transaction was viewed as a catalyst in the further liberalization of the financial sector and clearly represented ADB's firm support to the development of the PRC's market economy and to reform in the financial system.

25. At the time of ADB's investment in CEB, the domestic banking system in the PRC included three policy banks, four state-owned commercial banks (SOCBs), six commercial banks with a nationwide presence, seven other regional commercial banks, and three urban cooperative banks. Most of them were wholly state-owned and functioned largely as a conduit for government grants. The commercialization of the banking system was considered key to deepening financial reforms. In this context, ADB's equity investment in CEB was approved by the State Council as the first foreign investment in a local commercial bank. The investment was intended to introduce international commercial banking best practices and facilitate ownership diversification in commercial banks. The Project served as an example for other domestic banks to emulate and helped set the stage for similar investments by other potential foreign investors.

26. Since ADB's first direct equity investment in CEB, foreign investments in PRC banks have increased gradually and foreign banks are starting to play a more significant role as minority investors in domestic banks.<sup>7</sup> From 1996 to 2001, there were isolated transactions with niche players like the Bank of Shanghai and Nanjing Commercial Bank, and foreign portfolio investors were mainly multilateral financial institutions that had no active operational role. Since 2001, with the conclusion of the PRC's World Trade Organization negotiations, foreign banks' entry into the domestic banking sector has increased. Initially, foreign investments were limited to joint-stock commercial banks and city banks in major cities. The SOCBs were in a poor financial situation and foreign investors were mostly interested in the most potentially profitable geographical areas. Smaller banks also required smaller investments.

27. By late 2004, foreign investors' interest intensified further, as reforms in the SOCBs gathered speed and the Government began to permit higher foreign ownership. Foreign strategic investors have since entered in four of the five largest banks. The first major transaction was the purchase by Hong Kong and Shanghai Banking Corporation (HSBC) of a stake in Bank of Communications, the PRC's fifth largest bank, in 2004. Three of the SOCBs have foreign strategic investors as shareholders: the Bank of America in China Construction Bank, a consortium led by Royal Bank of Scotland in the Bank of China,<sup>8</sup> and a Goldman Sachs-led investor group in the Industrial and Commercial Bank of China. As of August 2008, there were 41 domestic banks with foreign investors. Appendix 1 provides a list of these banks.

28. The diversification of commercial banks' ownership structure has also been achieved through IPOs, which draw in a large number of private investors. Since 1999, a total of 14 PRC banks have been listed at various exchanges, raising a total of CNY514 billion. Among the top four commercial banks, three were listed in 2005 and 2006, while Agriculture Bank of China, the sole

<sup>7</sup> International Monetary Fund (IMF). 2007. *The Rise of Foreign Investment in China's Banks – Taking Stock*. IMF Working Paper WP 06/292. Washington, DC.

<sup>8</sup> ADB participated in the transaction and made an \$85 million equity investment in Bank of China.

bank out of the PRC's four SOCBs to remain unlisted, was transformed into a joint-stock company in January 2009, bringing it closer to its IPO plans. CEB has been actively preparing for public listing since last year and is looking to push this forward once the financial markets stabilize.

29. Injecting private ownership in domestic banks is integral to the regulator's road map for reform in the banking system. Traditionally, the wholly state-owned banks had weak credit culture, poor corporate governance, low efficiency and profitability, and were saddled with NPLs. Private ownership extends and deepens the oversight of banks; and creates positive effects on governance, technical and management skills, and financial performance.

30. The health of the PRC's banking sector improved significantly from 1996 to 2007, the period of ADB's investment in CEB. According to Fitch, the banking system-wide return on asset increased from 0.44% in 2002 to 0.89% in 2007. In the same period, the system-wide NPL ratio was reduced from 23.2% to 6.2%; the equity-to-asset ratio increased from 2.3% to 5.0%; and the total CAR increased from 7.8% to 11.4%.<sup>9</sup> However, it is important to note that the reform process is ongoing and necessary, and there remains room for improvement in the banking sector. An overview of the PRC banking sector is in Appendix 2.

## 2. Business Success

31. Table 1 summarizes the key financial highlights of CEB for the selected years 1997, 2006, and 2007.<sup>10</sup>

**Table 1: Key Financial Highlights**  
(CNY million)

Item	1997	2006 (pre-restructuring)	2007 (post-restructuring)
<b>Balance Sheet</b>			
Total Assets	60,920	596,117	739,354
Total Equity	5,584	(182)	24,689
Total Deposits	39,020	525,594	560,703
Total Loans	34,386	352,148	417,567
<b>Income Statement</b>			
Net Interest Income	2,352	12,950	17,772
Net Non-interest Income	48	592	1,190
Operating Income	2,465	13,793	20,044
Net Income	1,102	2,650	5,039
<b>Selected Ratios (%)</b>			
Return on Equity	19.73%	–	20.41%
Return on Assets	1.81%	0.44%	0.68%
Cost to Income Ratio	16.55%	39.37%	31.81%
Total Equity to Total Assets	9.17%	-0.03%	3.34%
Total Deposits to Total Liabilities	70.52%	88.14%	78.46%
Total Loans to Total Deposits	88.12%	67.00%	74.47%
Total Risk Weighted CAR	N.A.	(0.39%)	7.19%
NPL ratio	9.22%	7.58%	4.49%
Net Assets Per Share (CNY)	1.99	(0.02)	0.87

( ) = negative, NPL = nonperforming loan, – = not available

Source: China Everbright Bank, ADB analysis.

<sup>9</sup> Fitch. 2008. *Asia's Emerging Giants: Banking in China and India*. New York, 17 June.

<sup>10</sup> The first full year of operations after ADB's investment in CEB was 1997. The last full year of operations prior to the restructuring, which took place in December 2007, was 2006.

32. For equity investments that are not targeted at specific investment projects, real financial return on invested capital (ROIC)<sup>11</sup> is used as a proxy for financial rate of return. The 2007 ROIC is higher than the WACC plus 700 basis points. Based on the Guidelines, the Project can be rated “excellent”. However, this does not provide a complete picture of the Bank’s financial performance given that the 2007 ROIC was based on the Bank’s financials after restructuring and does not take into account the years in between where the ROIC was much lower than the WACC. In addition, the objective of the Project—to assist CEB in becoming a model commercial bank following international best practice principles—had not been completely achieved when ADB exited in 2007. Although CEB has made material changes in its corporate governance structure, the Bank is still developing its risk management infrastructure and practices in line with its growing business and the rapidly changing external environment. Although the restructuring and reform process has begun, it remains to be seen whether CEB can fully transition into the model bank it aims to become and whether it can generate strong financial performance going forward. Taking into account all these factors, the business success of the Project is rated “partly satisfactory”.

### 3. Economic Sustainability

33. ADB’s equity investment in CEB served as a catalyst to foreign direct investment in other PRC domestic banks, which in turn contributed to reform and transformation of the commercial banks. The continuing commercialization of the PRC’s domestic banks has a significant impact not only on the financial sector but also on the economy as a whole. By taking deposits and extending credit, a well-functioning banking sector allocates resources efficiently and provides fuel to economic development. The creation of stronger, more commercially oriented banks thus contributes to the creation of more efficient and effective intermediation of funds in the economy. In addition, the improvement in the domestic banks’ operational and management capabilities allows banks to access international capital markets, which in turn provide banks with greater flexibility to raise financing as required to meet the needs of the PRC’s rapidly growing economy.

34. Over the period of ADB’s investment, total banking asset increased from CNY9.5 trillion in 1997 to CNY45.4 trillion in 2007, representing a CAGR of 16.9%. Total loans increased from CNY7.5 trillion in 1997 to CNY26.2 trillion in 2007 (13.3% CAGR), while total deposits increased from CNY8.2 trillion to CNY38.9 trillion (16.8% CAGR) over the same period. The PRC’s economy also experienced rapid growth, with nominal gross domestic product (GDP) increasing from CNY7.9 trillion in 1997 to CNY 25.7 trillion in 2007, representing a CAGR of 12.5%. The bank assets-to-GDP ratio demonstrated an increasing trend and was 176.5% as of the end of 2007. Table 3 shows the strong growth of the PRC economy and financial sector from 1997 to 2007.

**Table 2: Development of the People's Republic of China Economy and Financial Sector**

Item	1997	2000	2003	2007
GDP (CNY billion)	7,897.3	9,921.5	13,582.3	25,730.6
Total Bank Assets (CNY billion)	9,500.8	13,548.4	22,531.3	45,426.8
Total Loans (CNY billion)	7,491.4	9,937.1	15,899.6	26,169.1
Total Deposits (CNY billion)	8,239.0	12,380.4	20,805.6	38,937.1
Total Bank Assets/GDP (%)	120.3	136.6	165.9	176.5
Total Loans/GDP (%)	94.9	100.2	117.1	101.7
Total Deposits/GDP (%)	104.3	124.8	153.2	151.3

GDP = gross domestic product.

Source: People’s Bank of China. 2007. *National Bureau of Statistics of China*. Beijing.

<sup>11</sup> ROIC = net profit/(shareholder capital + long-term subordinate debt).

35. The deepening of financial sector reform in the PRC was accompanied by the rapid development of SME, which play an important role in the private sector. By 2004, the PRC had 39 million privately owned SME, more than in the United States and Europe combined. SME generate half of the PRC's GDP, two-thirds of the country's exports, and three-quarters of new jobs.<sup>12</sup> The commercialization of the banking sector gave the banks flexibility to increase lending to SME, providing much needed finance to SME development. According to a People's Bank of China (PBOC) survey, as of August 2008, total outstanding loans to SME amounted to CNY1.14 trillion, which represented 53.4% of total corporate loans or 38.9% of total loans by all financial institutions.<sup>13</sup> Nevertheless, the private sector continues to need access to financing. To some extent, banks still favor SOEs over private enterprises, and bank lending remains focused on large corporate clients. It is expected that, with further banking sector reform, competition and bank innovation would induce or force the banks to provide increased financing to SME.

36. To quantitatively assess the Project's contribution to economic development, the economic return on invested capital (EROIC) was calculated, as the Project was not targeted at specific capital investment projects and the economic internal rate of return is not an appropriate measure. As of year-end 2007, the EROIC was in excess of 20.0%. Under the Guidelines, if the EROIC is greater than 20%, the Project can be rated "excellent". However, the EROIC over the period of ADB's investment went below 5%, which would yield an "unsatisfactory" rating. Looking at the overall picture, and evaluating both quantitative and qualitative factors, the Project's contribution to economic development is rated "satisfactory".

#### **4. Environmental, Social, Health & Safety Performance**

37. The Project carried an environmental category C as it was considered unlikely to have significant environment impacts. At the time of project approval, the FI<sup>14</sup> category for credit lines through a financial intermediary or equity investments in a financial intermediary had not yet been created, and ADB did not require categorization of projects on the basis of social safeguards. CEB was thus not required to implement an environmental management system. However, CEB's credit policies clearly stipulate that no credit should be provided to projects that violate state laws, regulations, and policies. On this basis, the Project was not rated based on environment and social performance.

#### **C. ADB Investment Profitability**

38. In November 1996, ADB invested a total of CNY165.9 million (\$20.0 million) in CEB. In December 2007, ADB exited the investment by exercising the put option resulting in total proceeds of CNY249.9 million (\$33.8 million). Taking into account the dividends received by ADB over the period of investment, the FIRR is 7.18%.

39. The report and recommendation of the President<sup>15</sup> identified a minimum FIRR of 7% under a worse case scenario (CEB's shares are not listed and ADB exercises the put option). The realized FIRR of 7.18% implies a multiple of 1.02 over the minimum return requirement, which yields a "satisfactory" rating based on the Guidelines.

<sup>12</sup> ADB. 2008. *Country Partnership Strategy, People's Republic of China, 2008–2010*. Manila.

<sup>13</sup> PBOC. 2008. *PBOC Monetary Policy Implementation Report, Q3 2008*. Beijing.

<sup>14</sup> Projects involving a credit line through a financial intermediary or an equity investment in a financial intermediary are categorized as FI.

<sup>15</sup> ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the People's Republic of China for the Everbright Bank of China Project and a Proposed Equity Investment in the Everbright Bank of China*. Manila. (Equity Number 7127-PRC for an equity investment RMB 165,999,600 approved on 5 November).

## **D. ADB Work Quality**

40. ADB's performance is rated "satisfactory" based on the following three categories: (i) screening, appraisal, and structuring of the Project; (ii) monitoring and supervision; and (iii) ADB's role and contribution.

### **1. Screening, Appraisal, and Structuring**

41. The Project was initiated from a PRC Country Programming Mission in January 1996 where the Government requested from ADB a \$60 million line of credit for CEB to augment its long-term foreign currency resources and to strengthen CEB institutionally. CEB was screened and finally selected for various reasons, including its healthy financial performance and its likelihood to succeed, to serve as a model for the other commercial banks to emulate. In the course of project processing, ADB was invited to participate in CEB's ongoing restructuring through participation in an equity investment. ADB considered that an equity investment in CEB would significantly expedite the reform process. ADB conducted full due diligence, which covered a review of the operational, management, and financial performance of CEB. ADB was provided with CEB's 5-year financial projections (1996–2000) based on CEB's strategic corporate plan under three scenarios: a base case scenario, a favorable case scenario, and an adverse case scenario. Based on these projections, ADB then assessed the (i) projected NAV of the shares; and (ii) projected share price based on the capitalized value of CEB's future earnings under the three scenarios, to determine the reasonableness of the CEB share price.

42. The overall Project had a hybrid structure, composed of a sovereign loan and capacity strengthening TA from the public sector department and nonsovereign equity investment by the private sector department. This innovative structure was the first public and private hybrid project carried out by ADB in the PRC, and it addressed the reform and development needs at both government and company level. The inclusion of TA was particularly helpful, as it provided for capacity building which an equity investment would not necessarily accomplish on its own.

43. The equity investment component was also well structured. ADB entered into a Shareholders Agreement with CEB with the following provisions: (i) a put option, (ii) the right to appoint a director on the board, and (iii) adoption of a charter in form and substance acceptable to ADB. The put option became instrumental in protecting ADB's investment at a time when CEB was encountering financial difficulties and was effectively operating with negative equity. Through its active representation on the board, ADB was able to introduce international best practices to CEB's operations. Overall, ADB's performance in project screening, appraisal, and structure is rated "excellent".

### **2. Monitoring and Supervision**

44. PSOD closely monitored CEB's performance and conducted regular reviews of the investment. It also prepared quarterly Private Sector Investment Management Notes on CEB, reflecting the latest information on the company.

45. CEB's weak financial position and issues on corporate governance were highlighted several times in ADB internal reviews. Based on these reviews, ADB proceeded to protect ADB's interest proactively through the put option. At the same time, ADB recognized the need to consider the long-term development impacts of its investment, and its strategic relationship with the Government and the regulatory institutions. Exercising the put option during CEB's planned IPO process would not only have sent a negative message about the Bank but also the financial sector in general. As such, ADB opted to negotiate the extension of the validity period twice instead of

exercising the put option. The negotiation of a minimum exercise price was also timely and vital in offering continuing protection to ADB. The put option effectively prevented ADB from realizing a loss on its investment in CEB.

46. The monitoring and supervision performed through the ADB-appointed board members were also broadly effective. ADB's nominee directors regularly attended board meetings and shareholders meetings and provided ADB feedback on issues discussed. As the most vocal members of the board of CEB, ADB's board representation was highly welcomed by the other shareholders as well as by the management of CEB. However, as a minority stakeholder, ADB was at times overruled by the other shareholders.

47. ADB's performance related to supervision and administration is rated "satisfactory".

### **3. ADB Role and Contribution**

48. ADB's investment in CEB's equity was the first foreign equity investment in a domestic commercial bank and demonstrated ADB's support for the PRC's banking sector reforms. These objectives were consistent with ADB's PRC country operations strategy at the time, which emphasized assistance to financial institutions that had the potential to be key change agents in the liberalizing economic environment. Upon its exit from CEB in 2007, ADB's investment in CEB continued to be relevant and consistent with the PRC country strategy, where the financial sector continued being one of the key focus areas of ADB's private sector assistance in the PRC.<sup>16</sup> In particular, ADB aimed to help strengthen banks and other financial institutions to enable them to mobilize resources better for the private sector and manage risk. Equity infusions into selected financial institutes were considered a means to promote financial sector reform and good corporate governance.

49. Through ADB's investment and active representation on the CEB board, coupled with the provision of TA, ADB was highly instrumental in pushing for improvements in CEB's corporate governance structure and the upgrading of its operations and management which, in turn, contributed to the strengthening and commercialization of PRC banks. ADB's role and contribution is therefore rated "satisfactory".

### **E. ADB's Additionality**

50. According to the Guidelines, additionality refers to the extent to which ADB's financing was a necessary condition for the timely realization of the Project, as well as to ADB's contribution to the design and functioning of the Project to improve development impact. ADB's equity investment in CEB was the first foreign equity investment in a PRC domestic banking institution. Banking is considered an industry with national strategic importance and at the time, there were considerable restrictions on foreign investment in domestic banks. As a development institution, ADB's participation did not carry the stigma of "foreign capital invasion", and was thus a suitable candidate to be the first foreign investor. In addition, ADB was able to structure the nonsovereign equity investment alongside the sovereign loan and capacity building TA, and to engage both the Government and CEB in the reform dialogue. Since ADB's investment in CEB, the Government has allowed and encouraged foreign investments in other domestic banks, contributing to financial market liberalization.<sup>17</sup> Evaluating ADB additionality in this wider context, it is rated "excellent".

---

<sup>16</sup> ADB. 2004. *People's Republic of China: Country Strategy and Program Update 2005–2007*. Manila (September).

<sup>17</sup> So far, 41 PRC banks have received equity investment from foreign investors. See KPMG. 2008. *Mainland China Banking Survey, 2008*. Beijing.

## F. Overall Evaluation

51. This section presents the overall rating of the investment in CEB, as justified by the underlying rating of development impact, ADB investment profitability, ADB work quality, and ADB additionality. The overall rating is “satisfactory”.

**Table 3: Evaluation of ADB's Equity Investment in China Everbright Bank**

Item	Unsatisfactory	Partly Satisfactory	Satisfactory	Excellent
<b>A. Development Impact</b>			√	
1. Private Sector Development			√	
2. Business Success		√		
3. Economic Development			√	
<b>B. ADB's Investment Profitability</b>			√	
<b>C. ADB's Work Quality</b>			√	
1. Screening, Appraisal, and Structuring				√
2. Monitoring and Supervision			√	
3. ADB's Role and Contribution			√	
<b>D. ADB's Additionality</b>				√

ADB = Asian Development Bank.

Source: Asian Development Bank.

## III. LESSONS AND RECOMMENDATIONS

52. The following are the key lessons and recommendations from the evaluation of ADB's investment in CEB:

- (i) Arrangements such as a put option or price adjustment mechanism offer valuable protection and should be negotiated for equity investments whenever possible. The documentation of such arrangements should be precise and unambiguous to avoid future disputes. In CEB's case, the exercise price of the put option was based on NAV. However, neither the Shareholders' Agreement nor the Subscription Agreement specified the accounting standard to be used in the calculation of NAV.
- (ii) Through its active participation on the board, ADB was in a position to provide valuable contribution to CEB, especially in the area of corporate governance, which was highly welcomed by other shareholders. However, ADB's role as an agent of change clearly had its limitations given that it was a minority stakeholder in CEB. Ultimately, the commitment of the controlling shareholder and the competency of management are the critical factors and the driving force behind the investee company's transformation. Although there seemed to be a shared vision among the shareholders for CEB to become a model bank, the actual transformation was slower than desired.
- (iii) The provision of capacity building TA alongside ADB's equity investment was a tool that helped CEB to upgrade its operations and management processes. The combination of TA and equity investment is a real value-addition that ADB brings to the table to its investee companies. This type of dual-assistance arrangement has been replicated in subsequent equity investments in PSOD and should be continued whenever possible.

- (iv) The preparation of this report highlighted the need for better project information maintenance on ADB's part. Some data were not readily available from the document files and a certain amount of external research needed to be done to obtain a complete picture of the issues surrounding ADB's investment in CEB. Standard information should be maintained and be readily available to enable the dealing officer to administer the Project effectively and efficiently and liaise with the project sponsor. This is crucial in cases where the dealing officer is neither the originating officer nor the director on the company board, and has to rely on project files to make decisions regarding ADB's investment.
- (v) Increased collaboration between ADB's public and private sector operations, whenever feasible and practical, is highly recommended. While the public sector operations has the expertise and experience to engage in policy dialogue with government and to promote sector reform at the macro level, the private sector operations build capacity and implement reform at the micro level. It is therefore, important to ensure close coordination between public and private sector operations at the country strategy planning stage to ensure that the priorities and focus of both are better aligned.

### FOREIGN INVESTMENTS IN MAINLAND PRC BANKS

PRC Bank	Foreign Investor	Stake Purchased (%)	\$ Million
Industrial and Commercial Bank of China	Goldman Sachs, American Express,	10.00	3,800.0
	Allianz Group		
	Kuwait Investment Authority	–	720.0
	GIC Direct Investments	–	360.0
	Chow Tai Fook, Sun Hung Kai	–	206.0
	Properties, Qatar Investment		206.0
	Authority, Hutchison Whampoa,		206.0
	United Overseas Bank, Nan Fung		206.0
	Group, Kuok Group		206.0
China Construction Bank	Bank of America <sup>a</sup>	10.75	4,369.0
	Asia Financial Holdings	5.10	1,460.0
Bank of China	Royal Bank of Scotland	5.00	1,600.0
	Merill Lynch, Li Ka-Shing	5.00	1,500.0
	Asia Financial Holdings	5.00	1,500.0
	Bank of Tokyo-Mitsubishi,	0.20	180.0
	Bank of East Asia,	0.20	180.0
	Chow Tai Fook,	0.20	180.0
	Kuok Group	0.20	180.0
	Nan Fung Group	0.20	180.0
	Hutchison	0.20	180.0
	Sino Land	–	159.0
	UBS	1.60	500.0
	Asian Development Bank	0.24	75.0
Bank of Communications	HSBC <sup>b</sup>	19.90	2,027.0
Bank of Dalian	Bank of Nova Scotia <sup>c</sup>	19.99	
	International Finance Corporation	5.00	321.0
	(IFC)		
Shanghai Pudong Development Bank	Citigroup <sup>d</sup>	3.78	67.0
Minsheng Bank	IFC	0.93	23.0
	Temasek Holdings <sup>e</sup>	3.30	110.0
Industrial Bank <sup>f</sup>	Hang Seng Bank	12.78	208.0
	IFC	3.20	52.0
	GIC Special Investments of	4.00	65.0
	Singapore		
Huaxia Bank	Deutsche Bank <sup>g</sup>	13.70	879.0
	Sal Oppenheim	4.08	
Guangdong Development Bank	Citigroup <sup>h</sup>	20.00	3,100.0
	IBM	4.74	165.0
Bank of Beijing <sup>i</sup>	ING Group	16.07	215.0
	IFC	4.04	54.0
Bank of Shanghai	HSBC	8.00	63.0
	Shanghai Commercial Bank	3.00	23.0
	IFC	7.00	47.0

<b>PRC Bank</b>	<b>Foreign Investor</b>	<b>Stake Purchased (%)</b>	<b>\$ Million</b>
Bank of Nanjing	IFC <sup>j</sup>	5.00	27.0
	BNP Paribas	12.60	87.0
China Bohai Bank	Standard Chartered	19.99	123.0
Bank of Hangzhou	Commonwealth Bank of Australia	19.99	78.0
	Asian Development Bank (ADB)	4.99	30.0
Xi'an City Commercial Bank <sup>k</sup>	IFC	1.50	20.0
	Bank of Nova Scotia	1.40	20.0
Ping An Bank <sup>l</sup>	HSBC	27.00	–
United Rural Cooperative Bank of Hangzhou	Rabobank	10.00	31.0
	IFC	5.00	
Nanchong City Commercial Bank	Deutsche Investitions-und Entwicklungsgesellschaft (DEG)	10.00	31.0
	Sparkassen International Development Trust (SIDT)	5.00	
China Everbright Bank	ADB	2.00	20.0
Bank of Tianjin	ANZ Bank	19.90	120.0
Tianjin Binhai Rural Commercial Bank	IFC	10.00	
Shanghai Rural Commercial Bank	ANZ Bank	19.90	263.0
CITIC Bank	Benco Bilbao Vizcay Argentaria (BBVA)	5.00	635.0
	Mizuho Bank	0.18	51.0
Urumqi City Commercial Bank <sup>m</sup>	Habib Bank	19.90	–
Evergrowing Bank <sup>n</sup>	United Overseas Bank (UOB)	15.38	113.0
Jilin Bank <sup>n</sup>	Hana Bank	19.70	327.0
Bank of Qingdao	Intesa Sanpaolo	19.90	137.5
	Rothschild Bank	5.00	34.0
Xiamen International Bank	ADB	10.00	10.3
	Sino Finance Group	5.00	5.2
	Shinsei Bank	10.00	10.3
Changsha City Commercial Bank <sup>n</sup>	Groupe Banque Populaire (GBP)	20.00	29.0
United Commercial Bank <sup>o</sup>	Business Development Bank	100.00	205.0
Qingdao International Bank <sup>p</sup>	Hana Bank	72.30	25.0
Jinan City Commercial Bank	Commonwealth Bank of Australia <sup>q</sup>	11.00	17.0
Xiamen City Commercial Bank <sup>n</sup>	Fubon Financial Holding	20.00	34.0
Nan Tung Bank <sup>f</sup>	Morgan Stanley	100.00	–
Bank of Chongqing	Dah Sing Bank <sup>s</sup>	20.00	87.5
Bank of Ningbo	Oversea-Chinese Banking Corporation <sup>t</sup>	10.00	70.0
BNP Paribas (China) <sup>u</sup>	BNP Paribas	100.00	–
Shenzhen Development Bank	Newbridge Capital	16.70 <sup>v</sup>	150.0
Yantai City Commercial Bank <sup>n</sup>	Hang Seng Bank	20.00	111.0

PRC Bank	Foreign Investor	Stake Purchased	
		(%)	\$ Million
	Wing Lung Bank	4.99	28.0
Bank of Chendu	Hong Leong Bank (HLBB)	20.00	261.0

– = not available.

- <sup>a</sup> Bank of America purchased an additional 6 billion Hong Kong-listed CCB shares, boosting its shareholding in the bank to 10.75% for an additional \$1.8 billion.
- <sup>b</sup> HSBC raised its stake in BoCom to 19% after it was diluted to 18.6% in an initial public offering (IPO) in May 2007. The listed investment amount includes the additional \$280 million used to raise its stake.
- <sup>c</sup> Bank of Dalian has signed a memorandum of understanding (MOU) to sell a 20% stake to the Bank of Nova Scotia through a share placement. The sale has not yet been completed.
- <sup>d</sup> Citibank's original stakes of 4.6% was diluted to 3.78% following the IPO of Shanghai Pudong Development Bank.
- <sup>e</sup> Temasek's and IFC's original stakes were diluted to 3.3% and 0.93% respectively following the IPO of Minsheng Bank.
- <sup>f</sup> IFC, Hang Seng Bank, and GIS all diluted their stakes from the previous total of 24.99% following the IPO of Industrial Bank.
- <sup>g</sup> Deutsche Bank spent \$552 million to increase its stake from 9.9% to 13.7% in a private placement of Huaxia shares.
- <sup>h</sup> On 16 November 2006, a Citigroup-led consortium won the right to buy 85% of Guangdong Development Bank.
- <sup>i</sup> ING's original stake of 19.9% was diluted to just over 16% and IFC's 5% stake diluted to 4% following the IPO of Bank of Beijing. ING has since announced it plans to raise its stake back to 19.9%.
- <sup>j</sup> IFC initially took a 15% stake in Bank of Nanjing, a portion of which it sold to BNP Paribas.
- <sup>k</sup> IFC's and Bank of Nova Scotia's stakes were diluted during a private offering.
- <sup>l</sup> In February 2007, Ping An bought HSBC's 27% stake in the Bank for \$29.4 million and then merged it with the Shenzhen Commercial Bank.
- <sup>m</sup> Habib Bank and Urumqi City Commercial Bank signed an MOU in February 2006, but the deal has not yet been completed.
- <sup>n</sup> The deal has been agreed to, but is awaiting regulatory approval.
- <sup>o</sup> Business Development Bank was established in 1992 as the People's Republic of China's first foreign-owned bank under a special provision to assist in the importing of food from Thailand. Therefore UCB was able to acquire 100% of the bank.
- <sup>p</sup> This bank is a joint venture between Hana Bank and ICBC, hence why Hana Bank was able to take a controlling stake.
- <sup>q</sup> Commonwealth Bank of Australia has applied to the CBRC to raise its stake in Jinan City Commercial Bank to 20%.
- <sup>r</sup> Morgan Stanley was able to acquire this bank because Nan Tung is considered a foreign-funded bank as it was formerly owned by Bank of China's Macao subsidiary.
- <sup>s</sup> Dah Sing Bank increased its stake in Bank of Chongqing from 17% to 20% following CBRC approval but it has declined to say at what cost to the \$87.5 million only reflects the initial stake purchase of 17%.
- <sup>t</sup> OCBC's stake in Bank of Ningbo was reduced from 12.2% following the bank's IPO.
- <sup>u</sup> BNP Paribas (China) was previously known as The International Bank of Paris and Shanghai, and was established as JV between ICBC and BNP Paribas. In 2003, ICBC sold its stake to BNP Paribas, which it then renamed BNP Paribas (China)
- <sup>v</sup> Following the bank's share overhaul, Newbridge Capital's stake in the bank declined to 16.7% from 17.89%.

Source: KPMG. 2008. *Mainland China Banking Survey*. Beijing.

## OVERVIEW OF THE PEOPLE'S REPUBLIC OF CHINA'S BANKING SECTOR

### A. Introduction

1. The China Banking Regulatory Commission (CBRC) recorded a total of 8,877 financial institutions under its supervision as of 31 December 2007. The number of financial institutions was down steeply from 19,797 a year earlier, mainly as a result of consolidations among rural credit cooperatives (RCCs). The top five banking sectors in 2007, based on assets, were the big four state-owned commercial banks (SOCBs) accounting for 53.2% of total assets; shareholding banks with 13.8%; RCCs 8.3%; policy banks 8.1%; and city commercial banks (CCBs) with 6.4%.<sup>1</sup>

2. According to CBRC statistics as of the end of 2008, the total assets of the banking sector amounted to CNY62.4 trillion, an increase of 18.6% year-on-year. The assets of the large commercial banks were CNY31.8 trillion, an increase of 13.7%; the assets of the joint-stock commercial banks stood at CNY8.8 trillion, an increase of 21.6%; the assets of CCBs were CNY4.1 trillion, an increase of 23.7%; and the assets of other financial institutions reached CNY17.6 trillion, an increase of 25.8%.

3. During the same period, the total liabilities of the banking sector amounted to CNY58.6 trillion, an increase of 18.2% year-on-year. The liabilities of the large commercial banks were CNY29.9 trillion, an increase of 13.0%; the liabilities of the joint-stock commercial banks stood at CNY8.4 trillion, an increase of 21.1%; the liabilities of the CCBs were CNY3.9 trillion, an increase of 22.6%; and the liabilities of other financial institutions reached CNY16.5 trillion, an increase of 26.1%.<sup>2</sup>

4. This overview focuses on the top four banking sectors and does not cover policy banks and other sectors, including urban credit cooperatives, RCCs, foreign financial institutions, and finance companies.

### B. Big Four State-Owned Banks

5. The Government's overall financial reform strategy for the large banks involved four stages:

- (i) recapitalization of the banks through capital injections and nonperforming loan (NPL) transfers/sales,
- (ii) incorporation of the banks into shareholding structures,
- (iii) sales of minority stakes to strategic investors, and
- (iv) listing of banks in Hong Kong or People's Republic of China (PRC) stock exchanges.

6. Industrial and Commercial Bank of China (ICBC), Bank of China (BOC), and China Construction Bank (CCB) have already gone through all four stages. Agricultural Bank of China is next in line and has recently converted into a shareholding bank. Reforms on the first three banks have been largely successful and the quality of these banks is improving. Their financial performance, particularly asset quality and capital, are now much stronger, as reflected in higher share prices since their public listings. All three are now ranked among the world's 10 largest listed banks by market capitalization.

<sup>1</sup> KPMG. 2008. *Mainland China Banking Survey*. Beijing.

<sup>2</sup> China Banking Regulatory Commission news release. 2009, 16 January. *The CBRC: Total banking assets over RMB60 trillion*. Available: <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20090122AE90F4CC959BDCC3FFFA239DDB397600>

7. The Government has been very aggressive on the reform front. One of its main objectives is to invite foreign banks not just to attract foreign capital but also to help transform PRC banks into commercial entities. As such, the Government is using overseas stock exchanges' stringent requirements to help monitor banking practices, increase transparency, and improve internal controls. Government agencies, particularly People's Bank of China (PBOC) and China Banking Regulatory Commission (CBRC), are intent on pushing improved corporate governance in PRC banks.

8. ICBC, BOC, and CCB were able to meet the post-initial public offering (IPO) requirements on financial performance laid out by CBRC. These banks' returns on assets ranged from 0.54% (for Agricultural Bank of China) to 1.53% (for CCB) in 2007. Capital levels of the big SOCBs are low, but slowly improving. BOC's capital-adequacy ratio was 13.34% at the end of 2007, down from 13.59% a year earlier; on the other hand, CCB's capital-adequacy ratio was 12.58% at the end of 2007, up from 12.11% at the end of 2006.<sup>3</sup>

9. It remains to be seen how the large PRC banks will be able to leverage their extensive branch networks to improve market penetration of their different products while improving operating efficiency.

10. The current focus of state bank reform is on reducing NPLs and improving solvency, which are areas where government and external forces can help relatively easily. In the next stage, the banks will need to improve their efficiency, credit culture, capacity for innovation, and eventually their profitability and competitiveness. PRC banks must also strengthen their corporate governance and risk management infrastructures, which are still in the early stages of development. The banks, particularly the largest entities, must transform their operations from bureaucratic organizations into commercially oriented entities. Public listing of these banks help, to the extent that the market imposes external discipline on the institutions, but it remains to be seen whether the banks would continue to carry out policy functions if required. In addition, effective risk pricing would require a comprehensive database of credit records and a flexible market interest rate mechanism, which could still be years away from full implementation.

### **C. Shareholding Banks**

11. The PRC has 13 shareholding banks with national footprints and eight are listed domestically.<sup>4</sup> The Bank of Communications, the largest in terms of assets, completed an IPO on the Hong Kong Stock Exchange in June 2005. Over the last decade, the shareholding banks have expanded their market shares. Their total assets reached CNY7.2 trillion in 2007, or 13.8% of the system, versus 10.7% in 2003. In fact, their growth has been consistently faster than the industry as a whole, helped by the robustness of the economies in the affluent coastal cities where they are concentrated, cleaner balance sheets, and more entrepreneurial management.

12. While the shareholding banks are widely considered to be the best-run banking sector in the PRC, they will face severe challenges if they are to maintain this performance because of factors including loss of staff, shortage of capital, and heightening competition. In addition to being supervised by CBRC, the listed banks are supervised by the China Securities Regulatory Commission. Their financials have all been audited by a Big 4 audit firm using International Financial Reporting Standards (IFRS). The shareholding banks have stricter disclosure and

---

<sup>3</sup> Economic Intelligence Unit. 2008. *Country Finance China – Main Report: August 27, 2008*. Beijing

<sup>4</sup> Bank of Communications, China CITIC Bank, China Everbright Bank, Hua Xia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Bank, Evergrowing Bank, and China Zheshang Bank.

corporate governance requirements, but their average capital levels are constantly under pressure because of their fast growth, high dividend payouts, and lack of capital injection by the Government.<sup>5</sup>

13. As of June 2008, the shareholding banks have an average total capital adequacy ratio (CAR) of 10.1% and all banks meet the 8% regulatory requirement. The average core CAR is 7.8%. The shareholding banks have relatively better financial performances, with average return on capital of 30.14% and average return on assets of 1.44%.<sup>6</sup>

14. The shareholding banks were established in the late 1980s and early 1990s, except for the Bank of Communications. Their short histories make them relatively free of legacy lending, which is the main reason why their credit quality is better. As of June 2008, the average NPL ratio of shareholding banks is 1.65%. They are a lot more commercially driven and competitive. Nonetheless, these banks need to continue to improve their corporate governance, operational systems, processes, risk management, and competitiveness because of heightened competition in their markets and at the request of CBRC.

15. The shareholding banks may have better internal controls and risk management, but corporate governance issues are still apparent. Typically, their shareholders are state-owned enterprises (SOEs) or large corporations in the PRC, with the result that related-party transactions are not uncommon. Furthermore, shareholding banks are more closely tied to the well-being of their smaller corporate customers, a situation that makes them more susceptible to potential economic downturns.

16. The shareholding banks' fast growth provides pressure on capital. Since 2003, most have issued subordinated debt. However, as the large banks have completed their high-profile public listings and the domestic market has resumed listing activities, the shareholding banks are now in a better position to raise capital. Some, such as China Merchants Bank, Shanghai Pudong Development Bank, and China CITIC Bank, have announced equity-raising targets, which will help shore up their capital positions. Furthermore, foreign investments in shareholding banks have risen. Seven of the 13 shareholding banks already have foreign investors and several more are in talks with foreign investors.

#### **D. Credit Cooperatives**

17. Reform of the large and fragmented RCC sector, including the newly formed rural commercial banks and rural cooperative banks, is on track. In terms of consolidation, the number of RCCs has already been reduced to 8,348 at the end of 2007—down from 19,000 in 2006 and more than 30,000 in 2005. This has been largely due to restructuring efforts at the provincial level either through the (i) establishment of integrated provincial credit cooperatives, (ii) merger of RCCs and conversion into rural banks, and (iii) formation of rural cooperative banks with separate legal entities at municipal and county levels. At the end of 2007, they accounted for an estimated 8.3% of national banking assets, with assets of around CNY4.3 trillion.

18. Most RCCs are under-reserved and inadequately capitalized. They have also been plagued by unclear ownership structures as well as management and accountability problems. As such, they have been unable to jump-start government efforts to rejuvenate the rural economy. Instead of making loans to the farming sector, some have invested in projects in the cities, with poor results. This also helps explain their weak profitability. Although some in the coastal regions are quite

<sup>5</sup> China Everbright Bank is the exception. The Government injected \$20 million equivalent in the bank in December 2007.

<sup>6</sup> Liu, M. K. 2008. *CBRC Chairman Speech on 2008 Conference of Shareholding Bank Presidents*. Beijing.

substantial in scope and operations, many in the more remote regions suffer from weak liquidity. This makes it hard for them to support rural areas, where over 70% of the country's population resides.

19. RCCs are expected to strengthen asset quality through NPL disposals. Their NPLs stood at 3.68% at the end of March 2008, compared with 5.32% a year earlier (footnote 3). If they reach certain "milestone" targets, they will be "awarded" central bank bills as additional capital. The long-term goal is to transform them into commercially oriented banks, while fulfilling the diversified needs of the farmers and the agricultural industry. The progress in mitigating the RCCs' legacy issue and historical burden should help clean up their balance sheets and improve the agricultural sector's financial system.

20. The central Government has injected more than CNY160 billion into reformed "qualified" RCCs in the form of central bank bills. In 2006, reforms spread to 29 provinces, and 93 rural banks and rural cooperative banks were set up. The longer-term goal is to consolidate the sector into about 2,000 entities, centralize control and operations, and thereby improve management and performance. The management system reform has largely been completed, with RCC management responsibilities transferred from PBOC to local governments. Some RCCs, particularly those in the more developed large cities (such as Hangzhou, Shanghai, Shaoxing, and Tianjin) have attracted foreign investments. For example, ANZ bought 19.9% of Shanghai Rural Bank, Rabobank and International Finance Corporation (IFC) jointly took a combined 15% stake in the United Rural Cooperative Bank of Hangzhou and plans to take a stake of about 10% in Binhai Rural Commercial Bank, which was formed out of a merger of three RCCs in Tianjin. With their experience and expertise, the entry of foreign investors should hasten reform of these banks.

## **E. City Commercial Banks**

21. The CCBs are an important part of the PRC's banking system. As of the end of 2007, total assets stood at CNY3.34 trillion, or 6.4% of total bank assets in the PRC, up 28.8% from the previous year. Currently, there are 124 CCBs.

22. CCBs have experienced divergent performances in the past few years, partly driven by the different stages of economic development in their respective areas. The large banks in relatively more affluent areas, where small and medium-sized enterprises have also grown strongly, have reported strong financial performance. In fact, some of the top CCBs have reported performance on a par with the top shareholding banks, such as the Shenzhen Urban Credit Cooperative Bank and Shanghai City United Bank. However, as a sector, they exhibit weaker corporate governance and asset quality. Their NPL ratio at the end of March 2008 was 2.90%, down from 4.52% at the end of March 2007.

23. As with the other banking sectors, CCBs are in the process of reforming rapidly. The reforms follow the four-stage strategy used by the large banks. CCBs' recapitalizations have been funded by both local governments and foreign investments. These banks have become popular targets for foreign investors, especially international financial institutions, primarily because they are the next tier of banks that could provide a meaningful entrance to the market once the foreign capital participations in CCB, BOC, ICBC, and major shareholding banks are completed. In addition, several of the CCBs present attractive franchise value given their geographic reach and branch networks.

24. Because of their relatively smaller size, in order to gain economies of scale, CCBs will need to grow either through regional expansion or through consolidation. In 2006, Huishang Bank

underwent restructuring by consolidating six CCBs and seven urban credit cooperatives in Anhui Province, while 10 urban commercial banks in Jiangsu Province were merged into Jiangsu Bank.

25. The CCBs are strongly linked to local governments; on average, local governments directly own an estimated 15% of the top 12 CCBs. The level of indirect ownership—through local government-owned corporations or investment companies—is much higher. On the positive side, the banks benefit from local government support, such as by securing deposits from government-related entities and projects, the introduction of business opportunities, and for some, local government recapitalizations through capital injections, and subsidies for NPL sales and asset swaps. On the negative side, local governments could interfere with management appointments and daily operations, creating large related-party transactions and loan concentrations in government-sponsored projects. Such actions could lead to asset quality problems. CCBs are less transparent than the larger state-owned and shareholding banks, partly because all are private and most have only started to disclose financial information publicly since the mid-2000s.

**PRIVATE SECTOR DEVELOPMENT INDICATORS AND RATINGS:  
FINANCIAL INTERMEDIARIES**

Indicators	Rating	Justifications
<b>1. Wider Sector and Economy Impact Beyond Intermediaries and Subborrowers</b>		
<b>1.1 Private sector expansion and institutional impact</b>		
1.1.1 Contribution to an increased private sector share and role in the economy, and to sustainable jobs or self-employment.	Excellent	<p>State-owned banks in the PRC were traditionally subject to direct government intervention and tended to favor SOEs. Commercialization of the PRC banking sector gave the banks the flexibility to increase lending to SMEs, providing much needed finance. As of August 2008, total outstanding loans to SMEs amounted to CNY1.14 trillion, which represented 53.4% of total corporate loans or 38.9% of total loans by all financial institutions.<sup>a</sup></p> <p>The deepening of financial sector reform contributed to the rapid development of SMEs, which had grown from being negligible players in the 1980s to becoming engines of growth that generated half of the PRC's gross domestic product, two-thirds of the country's exports, and three-quarters of new jobs in 2004. As of August 2008, SMEs accounted for 99.3% of the total number of enterprises, generated 55.6% of gross domestic product, 46.2% of tax revenue, and 75% of employment in the PRC.<sup>b</sup></p>
1.1.2 Contribution to expanded SME lending with good portfolio and sub-borrower performance.	Excellent	<p>By the end of January 2009, CEB's total loans to SME amounted to CNY237.9 billion, representing 40.2% of CEB's total corporate loans. This was a 13.3% increase over total SME loans as of year-end 2008 and a 39.8% increase over total SME loans as of year-end 2005. The NPL ratio on CEB's SME loans has also been reduced significantly from 10.89% at the end of 2005 to 2.51% at the end of 2008 (2.19% by the end of January 2009).</p>

Indicators	Rating	Justifications
<p>1.1.3 Contribution to institutional change by</p> <p>(i) improved supply and access generally to formal credit and banking service to SME, and</p> <p>(ii) influencing a more enabling environment for SME via policy dialogue, or otherwise, in which the participant bank(s) become more engaged.</p>	Satisfactory	<p>The increased available credit to SME was achieved through the commercialization of the PRC banking sector, to which the Project made a direct contribution.</p> <p>There has also been institutional change within CEB. In October 2005, CEB set up the Small and Medium Enterprise Management Center in Shanghai, a special unit responsible for the organization, promotion, and professional management of SME across CEB. CEB has formulated strategies and credit policies specifically targeted at the SME sector and introduced various measures that aim to improve financial service to SME. The Sunshine Care Plan, a financial service brand of SME finance by CEB, has developed a good reputation in the market.</p>
<p><b>1.2 Competition:</b> Contribution to new competition among local banks (including new product and service offerings) and/or contribution to increased competition in key sub-borrower markets.</p>	Satisfactory	<p>The commercialization and reform of the financial sector has led to increased competition between PRC banks. In response to competition and to diversify from SOE lending, which were the banks' traditional source of revenue, the banking sector has increased its portfolio of products and services targeted specifically at SME. New products developed include non-collateral based loans and credit products suited to SME cash flows. Other developments include the establishment of specific risk pricing mechanisms for SME borrowers by a number of banking institutions including CEB.</p>
<p><b>1.3 Innovation:</b> Contribution to new ways of offering effective banking services to clients in ways that are replicated by other banks and in the financial system.</p>	Satisfactory	<p>CEB has been successful in developing new products and services that were replicated by other banks. It was the pioneer in introducing same-day settlement for interbranch customers, electronic banking, renminbi and US dollar charge cards, and custody operations. In recent years, CEB has made specific innovations in service methods, service tools, service channels, service models, and organization management. For example, it offers over 20 innovative SME financing models through its corporate lending department, 60%–70% of which were introduced by CEB in the market. These financing</p>

Indicators	Rating	Justifications
		<p>models include several sophisticated and profitable products/services such as the “refund guarantee model”, “core client acceptance payment model”, “factory-merchant-warehouse-bank model”, etc. CEB was the pioneer in offering these innovative products to its customers, which eventually became standard products offered by other banks.</p> <p>Furthermore, CEB was the first commercial bank in the PRC that launched the CNY wealth management product. Apart from product innovation, CEB has developed innovations in the management and sales of wealth management products. In 2006, CEB was the first domestic bank to establish a wealth management center at headquarters, and it was the first to have an internal risk rating and external credit rating of its wealth management products. In 2007, CEB became the first bank to offer cross selling of wealth management products with regional banks. In the last 4 years, CEB has issued a total of CNY500 billion worth of wealth management products, and generated income of CNY910 million.</p>
<p><b>1.4 Linkages:</b> Contribution to local savings and deposits mobilization via networks of participant bank(s), and/or relative to size of sub-portfolios; contribution to notable upstream or downstream link effects to sub-borrowers’ businesses in their industries or the economy.</p>	Satisfactory	<p>By developing new products and services, and setting up an SME-focused business. CEB has played a role in channeling savings to investments. CEB has also developed more than 20 service models within its Golden Chain Financial Service to service the needs of upstream and downstream enterprises (suppliers, vendors, etc.) in an industrial chain.</p>
<p><b>1.5 Catalytic element:</b> Contribution to mobilization of other local or international financing to SME, and by positive demonstration to market providers of debt and risk capital to SME.</p>	Excellent	<p>From a macro-perspective, ADB’s investment in CEB was a pioneering transaction that facilitated foreign investment in other domestic banks. Between the time of investment and August 2008, 41 domestic banks received foreign investment, most of which are small regional/local banks that have significant SME portfolios.</p> <p>At the company level, CEB has also played a catalytic role in SME finance through the following: (i) building a comprehensive SME finance framework; (ii) pioneering and developing credit</p>

Indicators	Rating	Justifications
		operation models suitable to its SME clients; and (iii) organizing events and activities that provide value added to its SME clients, such as staff training, entrepreneur coaching, and enterprise consulting.
<p><b>1.6 Affected laws, frameworks, regulation:</b> Contribution to improved laws, regulation, and inspection affecting banks and banking services in the local financial system.</p>	Satisfactory	<p>The Project contributed to the easing of foreign investment restrictions in local banks, which is essential to the overall development of the banking sector.</p> <p>In terms of SME finance, CBRC has recognized the economic and growth implications of inadequate SME finance. In 2007, it called on banks to adjust their loan structures in favor of SME.</p> <p>CEB has directly participated in the consultation and development of laws, rules, and regulations concerning the PRC financial sector through:</p> <ul style="list-style-type: none"> <li>(i) providing feedback on the Employment Contracts Law to the China Finance Trade Union and the Supreme Court;</li> <li>(ii) providing feedback on the “Guidance to the Professional Acts of the Staff of Banking Financial Institutions” formulated by the Supervision Bureau of the Discipline Inspection Committee of CBRC;</li> <li>(iii) providing feedback on the “Work Ethics of Commercial Bank Staff” formulated by the China Banking Association; and</li> <li>(iv) participating in consultation meetings in the making of the Commercial Bank Law, Banking Supervision Management Law, Bill Document Law, Guarantee Law, Fiduciary Law, Bankruptcy Law, and Anti-Money Laundering Law.</li> </ul>
<p><b>1.7 Wide demonstration of new standards:</b> Contribution to raised standards in the financial sector in corporate governance, transparency, and stakeholder relations.</p>	Satisfactory	<p>There has been substantial improvement of corporate governance in PRC banks since 1996, specifically in terms of the level of professionalism and transparency. A major contributing factor to such development had been the entry of foreign investors in the banking sector.</p>

Indicators	Rating	Justifications
<b>2. Participant Banks and Sub-borrower impact</b>		
<b>2.1 Skills with wider impact potential:</b> (i) Contribution to improved credit approach at all stages in CEB in ways that will be replicated by other providers of finance and banking service; and (ii) contribution via CEB to improved sub-borrower skills in operation of their businesses, e.g., via good appraisal, conditioning, and monitoring by the bank(s).	Satisfactory	In 2005, CEB developed specific credit policies and procedures for its SME customers. The NPL ratio on the SME portfolio has also improved substantially—10.89% as of the end of 2005 versus 2.19% as of the end of January 2009.
<b>2.2 Demonstration and new standards-setting potential:</b> - As evident in affected and achieved standards in corporate governance and transparency, stakeholder relations, and in environmental and social spheres.	Partly Satisfactory	CEB has made some progress in terms of improving corporate governance over the period of ADB's investment, albeit at a slower pace and on a less comprehensive scale. Weaknesses in corporate governance (e.g., excessive exposure to related parties, insufficient loan loss provisioning, and inability to issue timely audited financial reports) were exposed when CEB encountered financial difficulties in the early 2000s. However, CEB has continued with its reform and restructuring efforts and some of the governance issues have been addressed.
<b>Overall Rating</b>	Satisfactory	

ADB = Asian Development Bank, CBRC = China Banking Regulatory Commission, CEB = China Everbright Bank; NPL = nonperforming loan, PBOC = People's Bank of China, PRC = People's Republic of China, SME = small and medium-sized enterprises; SOE = state-owned enterprise.

Note: Ratings scale: "excellent", "satisfactory", "partly satisfactory", "unsatisfactory". The rating is not an arithmetic mean of the individual indicator ratings, which have no fixed weights. Consider already manifest actual impact (positive or negative) and the potential impact and risk to its realization.

<sup>a</sup> People's Bank of China. 2008. *PBOC Monetary Policy Implementation Report, Q3 2008*. PRC.

<sup>b</sup> Ministry of Finance. 2008. *Thoughts on Improving Fiscal Supports to SMEs*. PRC (working paper).

Source: China Everbright Bank, ADB Staff Analysis.

