SECTION 3: CHINA'S STRATEGY AND OBJECTIVES IN GLOBAL CAPITAL MARKETS

Key Findings

- Inadequate corporate governance, disclosure, and accountability, poor regulatory supervision, rampant insider trading, frequent government intervention, and corruption continue to hinder the development of China's domestic capital markets. A related lack of confidence in China's domestic stock markets in Shanghai and Shenzhen has led to falling share values, which in June 2005 hit eight-year lows.
- Chinese firms continue to look to international capital markets to raise needed capital and enhance their global profile, though the location of such fundraising is shifting. China's international capital markets strategy appears to have shifted significantly toward listing on the Hong Kong Stock Exchange (HKEx). In 2004, Chinese companies listing in Hong Kong raised $12 billion, up from $7.5 billion the year before.
- In 2005, Chinese companies have largely forgone listings on the New York Stock Exchange (NYSE). This is primarily due to the enhanced corporate reporting provisions of the Sarbanes-Oxley Act of 2002 (SOX). To circumvent the reporting requirements of SOX, Chinese state-owned enterprises (SOEs) wishing to make public offerings increasingly have used the 144A listing process to raise capital from institutional investors in the United States.[103] Privately owned Chinese companies have concentrated their listings on the NASDAQ.
- China is taking a dual approach to raising capital to shore up its principal state-owned banks, which have non-performing loan levels estimated at $350 billion to $550 billion. While China is preparing its largest state-owned banks for overseas stock market listings, it is also selling stakes in the banks to Western banks eager to gain a foothold in the Chinese banking sector. China Construction Bank (CCB) raised (U.S.)$8 billion in its October 2005 initial public offering (IPO) in Hong Kong and The Bank of China (BoC) intends to attract $5 billion or more capital in its own IPO planned for early 2006.
- China's fundraising in global capital markets has national security implications for the United States. The U.S. Treasury Department has identified a Chinese bank alleged to be involved in money laundering related to activities that could be financing North Korea's nuclear weapons programs and, according to press reports, is also investigating the Bank of China and another Chinese bank because of similar alleged activities.[104] This raises concerns about the nexus between Chinese banks listing on international capital markets and security-related abuses.

- Inadequate transparency and disclosure by Chinese firms prevent the U.S. government and investors from fully understanding the possible nexus between Chinese firms listing on U.S. and international capital markets and support for Chinese and other weapons proliferation activity. However, there is no doubt that some listed Chinese firms are involved in proliferation-related activities.
- Because the links between military and civilian control and production by Chinese SOEs remain opaque, investors can rarely be sure whether their investments are tied to PLA or other Chinese defense-related activities. However, there are indications that some publicly traded firms have connections to the PLA and other military-related activities.

Overview

In 2005, Chinese firms became the second largest group of recipients—second only to U.S. firms—of funds raised through global IPOs. Chinese firms have already attracted over $15 billion in 2005 and are seeking to raise over $20 billion, compared with approximately $14 billion in 2004 and $8 billion in 2003. Chinese IPOs are expected to generate what some analysts have estimated will be $550 million in profits and fees for securities firms assisting in various ways with the listings. While this figure is still only about one-third the amount of fees derived from U.S. listings, it surpasses income attributable to European listings for the first time.[105] Indeed, Chinese firms' IPOs have created a sellers' market resulting in massive oversubscription by investors wanting a share of China's economic success.

IPOs by Chinese firms remain largely the domain of SOEs. CCB and Shenhua Energy Co., China's preeminent coal producer, account for roughly $11 billion of the total projected proceeds of $20 billion from Chinese IPOs during 2005.

Since every firm incorporated in China must first receive government approval before listing on an exchange, the central government still has the final word on Chinese listings. This is especially true for SOEs, since they often require a "cleaning" process to ready themselves for the public scrutiny an international listing requires. This process combines a host of financial and production-related restructuring and marketing maneuvers to demonstrate management autonomy, transparency, and corporate governance improvements. In an attempt to avoid the political maneuvering that often accompanies efforts to obtain Beijing's approval for IPOs, many private Chinese firms have chosen, instead, to incorporate themselves in small island jurisdictions such as Bermuda and the Cayman Islands.[106]

China's listing of its four leading state-owned banks on international exchanges began this year with CCB and will continue in early 2006 with BoC. The Industrial and Commercial Bank of China and the Agricultural Bank of China are expected to follow in 2007 and 2008, respectively. Chinese authorities believe pressure to list internationally will spur Chinese banks to adopt international standards of capitalization and corporate governance.[107] The introduction of Chinese banks into U.S. and other international capital markets will present investors with a range of new challenges. The continuing close affiliations that exist between China's banks and firms supporting the military, and the state-directed nature of the Chinese banks' lending, leave these banks vulnerable to manipulation, unsound lending practices, and activities contrary to U.S. security interests. Recent reports of illicit activities at BoC and other Chinese banks call into question BoC's plans to list on the NYSE and may impair listings by other Chinese banks.

A reported investigation of possible linkages of the BoC and other Chinese banks to money laundering activities that could be financing Pyongyang's nuclear weapons programs has also heightened concerns regarding Chinese bank listings in international capital markets[108]—and regarding how Chinese firms and financial institutions use the funds they raise from U.S. and other investors.

China Looks to Global Capital Markets

Foreign investment has underwritten the lion's share of Chinese economic development, mostly in the form of foreign direct investment. However, a growing proportion of foreign funds has been accumulated via the debt and equity offerings of Chinese firms in international capital markets and, to a far lesser extent, in China's domestic markets. When China opened its first stock exchanges in the early 1990s, equity and bond sales were intended to further domestic economic reforms by increasing market influences in the economy and reducing the role of heavily indebted and politically driven, state-run banks in the Chinese economy.

China's Weak Domestic Capital Markets

China's experiment with capital markets began in 1986 when Shanghai and several other cities set up rudimentary trading systems. However, progress was slow and it was not until the Shanghai Stock Exchange was established in December 1990, followed a few weeks later by opening of the Shenzhen Stock Exchange, that a formal capital market system existed in China. Believing these exchanges would become a central element of China's economic reorganization, Chinese citizens jumped at the chance to invest; "stock fever" gripped China, causing share prices to surge and further encouraging Chinese investors. In August 1992, over a million would-be investors waited in lines to buy applications for stocks being issued on the Shenzhen exchange. When the applications ran out, 50,000 people rampaged through the streets, clashing with police and leaving two dead.[109] Despite these setbacks, bankers and investors from around the world praised Beijing. Their praise, unfortunately, was premature. China's domestic markets sputtered while connected lending from large, state-owned banks remained dominant, forcing private companies to look to international capital markets to meet their financing needs.

China's domestic capital markets in Shanghai and Shenzhen remain weak today. Between June 2001 and June 2005 the Shanghai Stock Exchange lost over half its value and hit an eight-year low.[110] Experts believe this is largely due to the lack of market forces and transparency in the process of pricing listings on that market. The two exchanges face problems including a frequent failure to set the IPO price by the time the prospectus is issued, poor regulatory supervision, rampant insider trading, frequent government intervention, a lack of corporate disclosure, and corruption. There have been criminal investigations related to eight listed companies, including an investigation of the chairman of the Shanghai-listed jeweler Diamond Co. who allegedly transferred $10 million in company funds into private overseas accounts and disappeared.[111] These developments have led to a widespread lack of confidence in the proper functioning of these exchanges. As a result, both private and state-owned Chinese firms have been increasingly active in international capital markets.

According to Howard Chao, who heads the Asia Practice at O'Melveny & Myers LLP, the principal reasons Chinese companies are avoiding domestic exchange listings are that:[112]

- China's domestic listing process can be very time consuming, sometimes taking as long as four years;
- Unlike the U.S. disclosure-based system, listings in China involve government approvals; these require, in part, meeting certain profitability and other financial thresholds that many companies are unable to meet;
- Shares held by the original investors in a domestically listed company are usually not tradable on the exchange and can only be sold in private transactions, so that a listing does not provide a viable "exit" for investors;
- Regulations in China make it difficult for the management of SOEs to participate in equity, whereas this practice is commonplace for companies listed in international markets;[113]
- Private sector firms in China have experienced significant difficulties obtaining government approvals to list domestically;
- Listing on a non-PRC exchange permits profits denominated in Chinese currency to be converted into other currencies offshore; and
- China's domestic exchanges have performed poorly over the past several years.

There are some signs the Chinese government is beginning to clean up and reform its domestic markets. In June 2005, Zhou Xiaochuan, governor of the People's Bank of China, said that an open-door policy regarding foreign investors would help China integrate with global capital markets and that the policy of allowing qualified foreign institutional investors (QFIIs) to invest in domestic markets was improving the ability of Chinese exchanges to price offerings more accurately.[114] Currently, China's A-share exchange is limited only to QFIIs that have received official approval to trade.

The Chinese Securities Regulatory Commission (CSRC) has established several policies to stimulate growth in China's domestic exchanges, but these policies have been largely unsuccessful. For example, stock-transaction charges have been cut significantly, and an attempt to clean up shaky brokerage houses is part of this effort. In 2004, over one-third of China's brokerage houses posted losses. Regulators and state-owned asset management companies have closed or taken control of 19 brokerage houses since efforts began in mid-2003.[115] They also have set up a $6 billion Fund to Protect Securities Investors to shield investors from brokerage house failures.[116] To date, the most aggressive move by the CSRC has been to forbid any IPOs on China's exchanges until the end of 2005.

China's Current and Future Capital Markets Strategy

U.S. Markets

The New York Stock Exchange

Over the past year, Chinese companies have eschewed listings on the New York Stock Exchange (NYSE) in favor of other international markets, particularly Hong Kong. Indeed, this year there have been no SOE or non-technology offerings by Chinese firms on U.S. exchanges. The concerns most often cited by Chinese firms contemplating U.S. listing are related to several requirements within the Sarbanes-Oxley Act of 2002 ("SOX"). In particular, SOX Section 302, which requires CEOs and CFOs to certify their company's annual and quarterly reports, and Section 404, which provides requirements for internal controls, are cited as the primary reasons that Chinese firms have begun avoiding U.S. listings. Increased reporting requirements under SOX have inflated costs and fees and have "shifted the cost-benefit balance in favor of not listing in the United States."[117] But beyond having concerns about SOX requirements, Chinese firms are concerned that additional requirements may be imposed on listed firms in the future.[118]

To avoid current and future SOX reporting requirements, Chinese SOEs have been utilizing the 144A listing process instead of traditional IPOs to raise capital. Rule 144A allows private placement to institutional investors—e.g. a hedge or private equity fund—after a public listing on the HKEx or another exchange. The ability to raise funds from U.S. institutional investors that this mechanism provides has reduced the need for Chinese issuers to incur the costs associated with meeting the disclosure and governance requirements mandated by SOX. As a result, Chinese issuances on the NYSE have fallen sharply while 144A listings have grown rapidly as shown in Figure 1.1:

Figure 1.1 IPOs By Chinese and Hong Kong Firms Domiciled in the United States

	1996–2000	2000–2005
SEC-registered IPOs	28	20
Rule 144a Offerings	10	32

Source: Thomson Financial Corporation.

Chinese firms are also wary of listing on the NYSE because of the relatively high risk of class action lawsuits compared to the risk of such lawsuits faced by companies listing on the exchanges of other countries. For example, in Hong Kong there are no specific procedures for shareholders to bring class action lawsuits, and in the case of a negative judgment the losing party must pay all legal fees. In comparison, in the past several years, Chinese companies Netease, Asiainfo, UTStarcom, Chinadotcom, China Life, Kongzhoing, 51job, and Sina that are listed on the NYSE have been sued in U.S. courts.[119]

NASDAQ Exchange

While there has been a drop in Chinese listings on the NYSE, the one category of Chinese companies that has continued to list on U.S. exchanges is Chinese technology firms. These companies tend to list on the NASDAQ Exchange (NASDAQ). During the "tech bubble" of the late 1990s several Chinese tech firms listed in the United States, but after the bubble burst there were virtually no Chinese technology IPOs in 2001, 2002, or 2003. In 2004, the Chinese technology sector reemerged and 11 companies launched IPOs. In 2005, Chinese technology issues started slowly but are now appearing more frequently; nine Chinese firms now are seeking to list on the NASDAQ. The Chinese firms listing on the NASDAQ are smaller, more technology-focused, and more entrepreneurial than those that have traditionally listed on the NYSE. Their IPOs generally share several characteristics:[120]

- They tend to be Internet, wireless, or value-added telecommunications firms
- Although headquartered in China, they often are incorporated in offshore locations and do not require Chinese government approval before they list on an exchange
- They are not SOEs, and their principal shareholders are the individual founders along with venture capitalists and private equity funds
- Their IPOs are relatively small, raising an average of approximately $100 million
- Their issues do not aid the Chinese government but instead enrich those who built the listing companies and their early investors

The NASDAQ-listed firms appear to have determined that the benefits of a U.S. listing outweigh the costs. Managers of these firms tend to be familiar with the U.S. capital market environment and their venture capital investors expect U.S. IPOs. This is because the NASDAQ tends to value technology companies at higher price multiples than other markets, including the HKEx; provides the liquidity necessary for exiting investors; and offers the most "credibility and cachet." [121] According to Howard Chao:

> *[C]ompanies of this type tend to be more familiar with U.S. disclosure rules, standards of corporate governance, and other market expectations. On average they tend to have higher management standards than many other Chinese companies. They tend to be more market-driven.*

Figure 1.2 China's 2005 IPOs on NASDAQ [122]

Company Name	Size of Deal	Release Date
Actions Semiconductor	*$225.0*	Late 2005
Baidu	$109.1	August 5, 2005
China Medical Technologies	$ 96.0	August 9, 2005
FocusMedia	$171.7	July 13, 2005
Hurray! Holding Co.	$ 70.5	February 4, 2005
Suntech Power	*$200.0*	Late 2005
Target Media	*$150.0*	Late 2005
Techfaith Wireless Communication Technology Ltd.	$141.4	May 6, 2005
Vimicro International	$100.0	Late 2005

Legend: All amounts are in millions of U.S. dollars.
* Values in *Italics* are estimates.

Hong Kong Exchange

Chinese firms increasingly have sought to list in Hong Kong rather than on mainland China or other international markets. Moreover, China's strategy toward company listings in international capital markets has shifted over the past year so that it now focuses almost exclusively on the HKEx. Companies listing on the HKEx increasingly believe that there may be limited value in seeking another international listing in light of the willingness of foreign investors to invest in Chinese companies listed only in Hong Kong.[123] As a result, the average price of IPOs in Hong Kong has risen dramatically to $180 million, compared to the average U.S. IPO at $220 million.[124] Market capitalization of Chinese companies on the HKEx is roughly $200 billion.[125]

Hong Kong is an increasingly attractive place for Chinese firms to list for several reasons:

- HKEx has a long history as an independent financial market
- Because of the culture it shares with the mainland, Hong Kong understands the mainland business climate and perspective
- HKEx provides investors the access to China they want while allowing Chinese firms access to international capital somewhat removed from Beijing's reach
- HKEx is a big and deep market that attracts funds from all over Asia and the rest of the world and can support the share price of large Chinese companies
- Hong Kong has a large number of investors knowledgeable about and interested in investing in China
- Investment banks, stock analysts, and other professional financial sector services traditionally have based their Asia operations in Hong Kong, and
- Underwriting and other transaction fees tend to be lower in Hong Kong than in the United States.

Hong Kong Listings Raise Concerns for Investors

Concerns about the corporate governance, disclosure, and transparency of Chinese firms have remained largely static since the Commission's 2004 Annual Report. The opaque nature of Chinese state-run firms has not changed. They still list only minority stakes and provide no minority shareholder rights to investors. However, since the demand has been high for Chinese offerings—most have been oversubscribed—Chinese companies now have leverage to resist disclosing all but the minimum required information. Consequently, investors do not know what lies behind the scenes of a Chinese listing in Hong Kong. According to Paul French of AccessAsia in Shanghai, "It [is] a seller's rather than a buyer's market and . . . [that] makes the investment process far more speculative than it might appear. Given pitiful dividends and hazy results, most investors are betting on China's future" rather than the futures of the specific Chinese companies in which they are investing.[126]

There is also cause for concern about the pipeline of Chinese firms seeking to list in Hong Kong. As described in the Commission's 2004 Annual Report, Chinese firms in the past have made dual listings in both Hong Kong and New York, but in 2005 this has not occurred. Chinese firms have sought to raise money in Hong Kong without a New York tranche. While it is too early to be certain, one possibility is that Chinese firms are being "warehoused" for Rule 144A listings in U.S. markets down the road. If many Chinese firms choose this option, there could be an avalanche of Chinese state-run firms raising capital from U.S. institutional investors over a relatively short period of time.

Another potential problem is the independence and oversight of the Hong Kong market. The Chinese government's control over its SOEs listed on the HKEx and its influence over Hong Kong could at some point present a conflict of interest. While the long-term implications of these relationships remain uncertain, the HKEx's financial authorities are taking preliminary measures to ward off potential trouble. This concern is particularly appropriate because there currently is no statutory mechanism for inquiry about the financial reports of companies listed on the HKEx.[127]

In October 2005, two cases came to light on the HKEx that underscore the need for just such a mechanism. In one case, state-owned oil giant China National Offshore Oil Corp. (CNOOC) was rebuked by the HKEx for selective disclosure of information without shareholder approval.[128] In the other case, state-owned Beijing Media Corp., that had collected $116 million in its December 2004 HKEx listing, saw two of its vice presidents detained and its shares lose over a quarter of their value.[129] In response, Richard Williams, head of listing at the HKEx, identified the problem: "There is nothing more corrosive of market confidence than the feeling that some investors are excluded from an inner circle of privileged counterparties."[130] Selina Sia, a Hong Kong-based analyst with UBS AG, commented that Beijing Media Corp.'s behavior "reflects poor company management. The company didn't say anything until newspapers reported it. I think it's quite irresponsible."[131]

Hong Kong's regulatory authorities are publicly seeking to "maintain investor confidence and uphold Hong Kong's standard of corporate governance" by securing enactment of a bill that has been proposed in the Legislative Council that would establish a Financial Reporting Council. This Council's primary responsibility would be to "conduct investigations and enquiries" to ensure the market functions independently and fairly.[132] Similar regulatory regimes for auditing and accounting have been established by other international exchanges. As Natalie Chung, Audit Manager of Deloitte Touche Tohmatsu, explained, "In order to maintain Hong Kong as a leading international financial centre and the premier capital formation center for China, the regulatory regime for the accounting profession should be enhanced and in line with other international markets."[133]

Other International Exchanges

Chinese firms have not been listing on European or other Asian exchanges with any regularity. In 2005, only a handful of relatively small Chinese companies have indicated they seek to list on the Singapore, London, or German exchanges. In the long term it seems unlikely these exchanges, with the possible exception of the London Stock Exchange (LSE), will attract a significant volume of Chinese IPOs.

This year the LSE made attracting mainland Chinese companies to its equity markets its number-one priority. The LSE was particularly interested in attracting the listings of large Chinese banks that expect to launch IPOs in coming months. In May, Martin Graham, LSE's director of marketing services, visited Beijing to promote London as a market for overseas Chinese listings.[134] LSE is offering itself as an alternative to the NYSE that avoids the increased disclosure and governance requirements and the risk of class action lawsuits that are deterring Chinese SOEs from U.S. listings.[135]

Japan's Tokyo Stock Exchange also has begun to attract Chinese firms with marketing visits to Beijing to promote its "public offer without listing" or POWL. According to Robert DeLaMater, "[t]his offering structure permits a company to conduct a public offering without being required, following the offering, to assume the burdens of a public listing and the ongoing disclosure and other obligations that a public listing would entail."[136] Several of the recent large Chinese privatization offerings—some totaling several billion dollars—have been conducted through this mechanism.

The Impact of Chinese Global Capital Markets Activity on U.S. Security

The Commission's 2004 Annual Report to Congress identified four security-related areas of concern regarding the listing of Chinese companies on U.S. and other international exchanges. These are (1) links between listed Chinese firms and weapons proliferators, (2) links between listed Chinese firms and the PLA and China's defense-industrial sector, (3) the way in which Chinese state-owned banks have provided subsidized financial support to Chinese defense-industrial firms, and (4) inadequate disclosure of the activities of listed Chinese enterprises in terrorist-supporting states such as Iran and Sudan. All of these continue to concern the Commission.

Listed Firms Involved in Proliferation

Inadequate transparency and disclosure by Chinese firms prevent the U.S. government and investors from fully understanding the possible nexus between Chinese firms listing on U.S. and international capital markets and support for Chinese and other weapons proliferation activity. However, there is no doubt that some listed Chinese firms are involved in proliferation-related activities.

The U.S. government has imposed sanctions on a number of Chinese companies, including quasi-governmental companies, for proliferation activities.[137] See Chapter 4, Section 2 of this Report, titled "China's Proliferation Practices and Record," for detailed information. Some of the sanctioned companies have ties to listed firms, and some of them are subsidiaries of prominent companies that do business in the United States. Examples include Nanjing Chemical Industries Group and Jiangsu Yongli Chemical Engineering and Technology Import/Export Corp. Both these organizations have been cited by the U.S. government for proliferating dual-use chemical precursors, equipment, and/or technology to Iran and have been under U.S. sanctions since 1997. Both are also subsidiaries of the Chinese oil and chemical giant Sinopec that has conducted joint ventures with U.S. companies and is listed on the NYSE, despite the fact that two subsidiaries were under U.S. sanctions at the time of the listing.[138]

Other Chinese firms sanctioned by the United States for proliferation include quasi-governmental firms such as North China Industries Corp. (NORINCO)[139] and China National Aero-Technology Import and Export Corporation (CATIC). CATIC was sanctioned for proliferation activities relating to its deals with Iran. This year CATIC has been particularly active in Zimbabwe, reporting sales of aircraft with both civilian and military capabilities.[140] CATIC is listed on the HKEx and the Berlin Stock Exchange. NORINCO is traded on China's Shenzhen Stock Exchange where it is available for purchase by Chinese and QFII.

Disturbingly, U.S. investors and government regulators have little information regarding any proliferation-related activities of U.S.-listed Chinese firms. To address this concern, the Congress established a requirement for an annual report by the Central Intelligence Agency concerning "whether any Chinese or other foreign companies determined to be engaged in the proliferation of weapons of mass destruction (WMD) or their delivery systems have raised, or attempted to raise, funds in the U.S. capital markets."[141] However, this requirement, established under the 2003 Intelligence Authorization Act (P.L. 107–306 sec. 827) was repealed in the 2004 Intelligence Authorization Act (P.L. 108–177 sec. 361e). The persistence of Chinese proliferation coupled with the growing number of Chinese firms entering international capital markets urgently requires the reinstatement of this reporting requirement.

President Bush's Executive Order on WMD Proliferation Financing

On June 29, 2005 President Bush issued Executive Order 13382. Its purpose is to freeze the assets and restrict the activities of WMD proliferators seeking to raise funds in the United States or financially interacting with American companies. It also contains authority to penalize financial institutions found to be supporting proliferators. According to Secretary of the Treasury John Snow, "This Order sends a clear message: if you deal in weapons of mass destruction, you're not going to use the U.S. financial system to bankroll or facilitate your activities." Executive Order 13382 should help invigorate U.S. government efforts to identify and restrict U.S. investment in firms with proliferation-related ties.

Continued PLA Involvement in Chinese Enterprises

In 1998, then-president of China Jiang Zemin ordered the PLA to divest itself of the commercial enterprises that it had established or acquired through the 1980s and 1990s. The divestiture effort did not, however, sever links between the PLA and the defense-industrial sector. On the contrary, civil-military cooperation in the defense-industrial sector appears to have strengthened during the past few years. Additionally, thousands of smaller, subsistence-oriented enterprises remain directly under the PLA.[142] Eliminating direct or indirect involvement of the PLA from the operation of an enterprise remains difficult due to the nature of SOE reforms and SOE corporate governance structures. The operation of the SOE asset management system continues the decisionmaking process whereby key corporate leaders are chosen by party and state institutions.[143] According to Christopher McNally, in the case of the Shanghai holding corporations: "The party committee's central role in the corporate decision making process aggravates a common governance problem: the division of labor between institutions representing ownership (board of directors) and management is illusory."[144] In the case of companies under such a structure, investors can rarely be sure whether their investments are tied to PLA or other Chinese defense-related activities. As an example, at least one subsidiary of China State Shipbuilding Corporation (CSSC), a large industry group responsible for significant amounts of Chinese naval and merchant ship construction, is listed and publicly traded on the Hong Kong stock exchange. It is impossible for investors to determine the full extent of the listed subsidiary's management and production integration with naval military activities of other CSSC subsidiaries or the parent corporation.

China's State-owned Banks

For some time, China has aspired to list its four leading state-owned banks on international exchanges; CCB led the way, listing on the HKEx on October 21, 2005 (and raised $8 billion). Chinese authorities believe pressure to list internationally will spur its banks to achieve international standards of capitalization and corporate governance that will help them compete with foreign banks when protectionist government regulations are lifted in 2006.[145] This is a large step for these quasi-government institutions whose leaders are unaccustomed to opening their books to public scrutiny.

An evaluation of the Chinese banking sector provides cause for both optimism and pessimism. Among reasons for optimism: The Commission heard testimony that while all top officials at China's financial sector regulatory agencies, the Central Bank, and the major state-owned banks are senior CCP members and political considerations are involved in their appointments, the government is trying to reduce the Party's political influence in those organizations. Efforts are being made to bring large state-owned banks in line with international accounting norms. And last year there was a reduction in the percentage of loans by China's banks that are nonperforming (NPLs). Those NPLs are estimated to have a current aggregate value between $350 billion and $550 billion.[146] It is important to note, however, that a massive lending binge temporarily reduced the percentage of Chinese bank loans that are nonperforming, but that binge ironically could lead to a new wave of NPLs in coming years, particularly if the Chinese economy continues to slow.

Unfortunately, a number of reasons for pessimism about Chinese banks remain. While the large state-owned commercial banks are working to improve their lending practices, over 60 percent of incremental lending in China between the last quarter of 2002 and the second quarter of 2004 came from small banks, mostly owned by local governments.[147] Reform efforts at these smaller banks are less well developed or absent altogether. Lending without proper due diligence remains common. Tens of millions of dollars were stolen from Chinese banks last year alone, often by or with the complicity of bank officials. For example, in March 2005 regulators uncovered an $18 million fraud at the Agricultural Bank of China. CCB Chairman Zhang Enzhao resigned amid reports that he had taken $1 million in kickbacks. Meanwhile, investigators found over $122 million missing at a local BoC branch.[148] Effectively addressing the extensive corruption in the Chinese banking sector requires Western-style regulation and application of severe penalties for financial fraud.[149] Despite the discouraging occurrences, however, just the discovery of these frauds is an indication that some change is beginning to occur in the Chinese banking sector.

The overall—and certainly mixed—picture concerning the reliability and integrity of Chinese banks should raise significant concerns for potential investors. Investor confidence depends on setting free China's banks from CCP control, allowing the banks to operate according to and consistent with commercial standards, and establishing and rigorously enforcing sound and sufficient transparency, governance, and accountability regulations. Until these steps are taken, investors will not have adequate information to be confident that investments in the banks will be safe and prudent and will not end up helping bankroll Chinese military programs, WMD proliferation, politically directed but uneconomical commercial activities, or enrichment of bank executives and CCP officials.

As cases in point: despite the excitement generated by CCB's recent IPO, Moody's Investor Service gave the bank's financial strength a very poor rating.[150] The bank's prospectus confirms CCB's weak financial position: "Our allowance for impairment losses may not be adequate to cover future actual losses to our loan portfolio."[151] The BoC lags behind CCB in a host of key indicators including profitability. Nonetheless, it aspires to achieve a higher valuation than its rival.[152]

Figure 1.3 Expected International IPOs of Chinese State Owned Banks

Bank Name	Market	Capital Raised in IPO (millions of U.S. dollars)	Actual or Anticipated IPO Date	State Owned?
Agricultural Bank of China	N/A	N/A	2008	Yes
Bank of China	HKEx, NYSE	$ 5,000*	Early 2006	Yes
Bank of Communications	HKEx	$ 1,880	June 23, 2005	No
China Construction Bank	HKEx	$ 8,000	October 21, 2005	Yes
Industrial and Commercial Bank of China	N/A	$10,000*	2007	Yes
Industrial Bank of Fujian	HKEx	N/A	2006	No
Minsheng Banking Corp.	HKEx	$ 750*	November 2005	No

*All values are approximate.
Legend: All amounts are in millions of U.S. dollars.

Equity Stake Sales to Foreign Banks

China is taking a two-pronged approach to raising capital vis-à-vis its state-owned banks. While it is preparing its largest state-owned banks for overseas stock market listings, it also is selling stakes in these and other banks to Western firms eager to gain a foothold in the Chinese banking sector. Between January and October, foreign banks have agreed to invest more than $15 billion in Chinese lenders.[153] Bank of America, Royal Bank of Scotland, Deutsche Bank, and HSBC are among those seeking stakes in China's state-run banks. These transactions likely are more important to the Chinese for the international financial sector relationships they establish and cultivate and the incentives they provide to Chinese banks to improve their corporate governance methods and procedures than they are for the cash they attract.[154] The foreign banks see such investments as a means of entering an expanding and potentially lucrative Chinese market. These investments are subject to essentially the same set of problems for investors to which Chinese bank IPOs are subject, and institutions considering such investments should be as cautious as individuals and institutions considering purchasing the listed stocks of these banks.