

The Impact of Foreign Strategic Investors' Shareholding Changes on China's Commercial Banks under the Impact of International Liquidity Crisis—Targeting at Bank of China and its Foreign Strategic Investors in Financial Crisis

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Abstract: China's commercial banks have been keen to introduce foreign strategic investors to help with management since 2003. Banks of different levels, from the four well-known state-owned banks, including the 'Universal Bank', ICBC, to urban commercial banks, have made different types of attempts. Among those cases, the mass introduction of foreign strategic investors to four state-owned banks is the stereotype. With the help of foreign strategic investor, China's commercial banks could not only absorb piles of foreign investments and learn about advanced risk management system and operation experience, but also improve their lagging information disclosure process, enhancing the competitiveness domestically and internationally. With the outbreak of financial crisis in 2008, the need of liquidity had reached the peak. Coincidentally, it was exactly the time for most foreign strategic investors passing through their shareholding restricted period, so most of them sold their shares of China's commercial banks to cash out. The Union Bank of Switzerland (UBS) sold all shares of Bank of China (BOC) at the end of December in 2008, becoming the first foreign strategic investor to quit Chinese market. After that, other foreign strategic investors withdrew their capital gradually during the following two years. Thus, it is important to think twice about the positive influence brought by foreign strategic investors and the negative impact when they quitted market. Among all the foreign strategic investors of China's commercial banks, the Union Bank of Switzerland was the most obvious share seller, who sold 3.38 billion shares of Bank of China, cashing out about 8000 million dollars in 2008. Bank of China is not only an influential bank in China, with large scale of assets and wide range of business, but also an outstanding bank internationally. When BOC cooperated with the Union Bank of Switzerland (UBS), The Royal Bank of Scotland Group Public Limited Company (RBS), Temasek Holdings and Asian Development Bank (ADB), the BOC has greatly improved a large number of areas, including private finance, corporate finance, human resources, inner supervision and so on. Therefore, the author chose the Bank of China and its foreign strategic investors as the main object to discuss about the influence of the reduction of shareholdings on BOC, under the impact of international financial crisis in 2008.

The history of the introduction of foreign strategic investors to China's commercial banks is not so long. However, the influence of that has come to light in the past about ten years. Though many commercial banks have introduced foreign strategic investors to help with their management, fewer people have focused on the influence of their withdrawal on China's commercial banks after the restricted period [1].

Most academics mainly paid attention to principles commercial banks should obey and points they should consider at the point of introducing foreign strategic investors. For example, Wang, Yang, and Xu (2017) developed an empirical model to prove that the introduction of foreign strategic investors has increased the capital adequacy ratio and off-balance sheet business ratio. In the meanwhile, it has reduced NPL ratio and asset-liability ratio. Some academics have also conducted research on the influence of commercial banks when their foreign strategic investors sold shares in a short time. Yuan (2016) took Industrial Bank as sample, finding that the exit of foreign strategic investors had negative

influence on management structure of Industrial Bank. Tian (2016) and Cai (2015) all focused on China Construction Bank(CCB) and its foreign strategic investor, Bank of America. Both of them have discovered that the reduction of shareholding of Bank of America negatively influenced corporate governance while had no obvious influence on operation performance.

1. Background Information

1.1 The Introduction of Foreign Strategic Investors

Since it was illegal for foreign financial institutions to hold shares of China's commercial banks, both ADB holding China Everbright Bank and IFC holding Bank of Shanghai were exceptions approved by China's State Department. Even though they didn't have any business or technique cooperation and the ratio of shares that foreign investors held was at a very low level [2].

Time came to 2005, with the introduction of RBS, UBS and ADB to the BOC and the introduction of the Bank of America to CCB, five supervision institutions, including China's Ministry of Commerce, Security Regulatory Commission and State Administration of Foreign Exchange published *Regulatory Principles for Foreign Strategic Investors to Invest China's Listed Companies jointly*. Since then, the introduction of foreign strategic investors to China's commercial banks became one of the important ways for the development of commercial banks. The proportion of the foreign investors of China's commercial banks reached a peak in 2007, contributing to over 2.4% assets of commercial banks in China. It was followed by more revision of Regulatory Principles for Foreign Strategic Investors to Invest China's Listed Companies, since it was the guideline of all foreign investment and should be adaptable to different stages of China's commercial banks development.

1.2 International Liquidity Shocks

When the financial crisis broke out in 2008, western developed countries, represented by USA, were the first ones to come into economic predicament. In the middle of July of 2008, two famous tycoons of mortgage loans in America, Freddie Mac and Fannie Mae, suffered a big loss of over 70 billion dollars and were taken over by US government in the end. However, the US government couldn't always be the saver [3]. With the rejection of saving Lehman Brothers Holdings, it finally broke down and aroused huge waves in financial market, domestically and internationally. Market confidence suddenly collapsed and the stock prices experienced dramatic drop. Under this circumstance, the liquidity was severely needed on the market. Though the US government carried out rounds of financial aids to try to help the poor stock prices, it didn't make too much sense. Represented by short-term interest rate, traditional monetary policies were out of order.

The Wall Street tycoons in the past could no longer maintain their confidence and optimism; they all took various measures actively to try to save themselves. These measures include collecting huge amount of capital, eliminating problematic assets and selling most of the shares they held. Then the need of capital and liquidity became the most emergent issue for all financial institutions

1.3 Crazy Oversell of China's Foreign Strategic Investors

China had become more open to foreign capital since it joined WTO. With the establishment of China Banking Regulatory Commission in 2003, more foreign strategic investors have been introduced to commercial banks gradually. China's four representative state-owned banks (except Agricultural Bank of China) mainly introduced foreign strategic investors between 2004 and 2006. According to Regulatory Principles for Foreign Strategic Investors to Invest China's Listed Companies, foreign strategic investors must hold shares of China's listed companies for at least 3 years. That is to say, 2007~2009 was exactly the period that most foreign strategic investors could sell their shares in hand [4].

For foreign strategic investors of BOC, UBS sold all shares at the end of 2008, cashing out about 8000 million dollars; RBS sold 10.8 billion shares of BOC at a time a month after the restricted period;

other 6 foreign institutions who invest BOC indirectly through RBS sold shares as well. Another state-owned bank, China Construction Bank, also experienced huge and sudden stock sell-off. Bank of America sold shares of CCB in four rounds since 2009, cashing out 220 billion Hong Kong dollars in total, which was about 28 billion dollars.

2. Case Study

In order to analyze the impact of foreign strategic investors' shareholding changes on china's commercial banks under the impact of international liquidity crisis comprehensively, writer mainly introduce corporate operation and governance these two aspects which shareholding changes may have influence on. In addition, there is a following case in which we could see more details of BOC when it experienced shares sold-off between 2008 and 2009 to see in which areas BOC was influenced under the impact of liquidity crisis.

2.1 How Would Shareholding Changes Influence China's Commercial Banks

The original intention of China's commercial banks to introduce foreign strategic investors was to obtain foreign capital, as well as learn the advanced management system and product invention through the method of strategic cooperation, so as to upgrade their financial product and technology systematically. It was not hard to understand that the higher ratio of shareholding, the more profound influence would strategic investors had on China's commercial banks. Then it was the same when foreign strategic investors became to decrease their shareholding ratio. Undoubtedly, those commercial banks who had introduced foreign strategic investors to would experience changes and fluctuation in their operation more or less.

CAMEL, one of the most internationally popular rating systems for the business performance of commercial banks, includes capital, assets, management, earning and liquidity these five indicators to evaluate the operation performance of commercial banks. Three principles of managing commercial banks are safety, liquidity and profitability. Therefore, writer combined these two important references together and chose financial indicators to analyze the influence of reduction of shareholding intensively.

Table 1 Financial Indicators

	Indicators	Formula	Explanation
Safety	Non-performing Assets Ratio	Troubled Assets/Total Assets	Indicate the risk level of commercial banks
	Preparation of Coverage	Loan Loss Reserve/Troubled Loans	Evaluate whether risks are under control
	Capital Ratio	Capital/Total Risk Assets	Indicate the ability of paying debts
	Core Capital Adequacy Ratio	Core Capital/Total Risk Assets	Evaluate whether capital structure is reasonable
Liquidity	Liquidity Ratio	Current Assets/Current Liabilities	Evaluate liquidity
	Loan-to-deposit Ratio	Loans/Deposits	Evaluate the efficiency of using capital
Profitability	Net Assets Returns Ratio	After-tax Profits/Net Assets	Evaluate the efficiency of using proprietary
	Commission-to-returns Ratio	Commission and Fees/Operating Income	Evaluate the ability of innovation

According to corporate governance theory, shareholding structure is an important aspect of corporate governance. The influence of foreign strategic investors on shareholding structure was shown on the changes of proportion of shareholding, and that on corporate governance was shown on changes of top management, including board of directors and board of supervisors.

It was known to all that for most China's commercial banks, state-owned and corporate shares or

state-owned shares played the most important roles no matter in the ratio of shareholding or the influence of corporate governance. With the introduction of foreign strategic investors, this situation would change somehow. This could not only help restrain and guide managers, but also stimulate other institutional investors to follow foreign strategic investors' investment. When foreign strategic investors became to sell most of the shares they held, the reasonable shareholding structure might change a lot or even get destroyed.

In terms of corporate governance, strategic investors would send directors to China's commercial banks directly, breaking the former structure which had strong administrative color. This would help promote the marketization of electing directors. The motivation of doing so was that foreign strategic investors could make profits through the upgrade of corporate governance and the excess returns because of that. However, with the decrease of shareholding ratio, the amount the foreign strategic investors spent to supervise and manage those commercial banks could not be made up for by the capital gains they got from stock market. Thus, they would not govern the bank actively. Consequently, it could not help upgrade the corporate governance structure of China's commercial banks. In order to figure out whether the reduction of shareholding had influenced the corporate governance of China's commercial banks, writer would discuss the change from the structure of shareholding, board of directors and board of supervisors these three aspects.

2.2 The Impact of Shareholding Changes on BOC

The decrease of the shareholding of foreign strategic investors of BOC mainly took place between 2008 and 2010. In order to figure out the complete impact of the shareholding changes, writer chose data from a time period of 2007 to 2013 to discuss the impact.

In order to exclude the influence of other non-variable factors, the paper adopted comparative analysis to compare the performance of BOC and ABC (Agriculture Bank of China), who didn't introduce foreign strategic investors, to find the differences between them. Since BOC and ABC were very similar in other fields, we could say that the differences mainly came from the shareholding changes of foreign strategic investors of BOC, such as UBS.

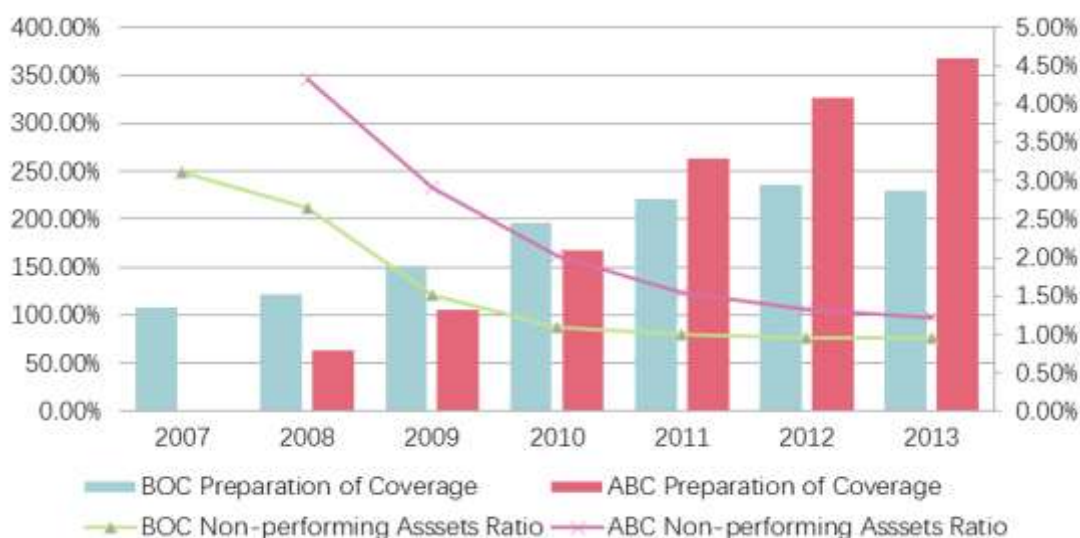


Figure 1. The POC and NAR of BOC and ABC between 2007 and 2013

It is shown in Figure 1 that in terms of non-performing assets ratio (NAR), BOC experienced an obvious decrease since foreign strategic investors were introduced. However, this trend disappeared gradually since 2009. It was reassuring that the NAR of BOC didn't go up but maintained at the level of 1%. Thus, the influence placed on BOC by foreign strategic investors was long-lasting. Strategic investors' leaving was not quite harmful, though the decreasing effect of NAR disappeared.

When it came to preparation of coverage (POC), the effect of foreign strategic investors' leaving was much more obvious. The POC of BOC was much larger than that of ABC before 2009. But the

gap became increasingly smaller since 2009, and ABC even overpassed BOC in 2011. After that, the POC of ABC grew up continuously, but by contrast, the POC of BOC started to maintain at a stable level. So we could say that the sell-off of foreign strategic investors after the break out of financial crisis in 2008 influenced BOC to a certain degree. It was the adequate troubled debt preparation that supported BOC to deal with the shock.

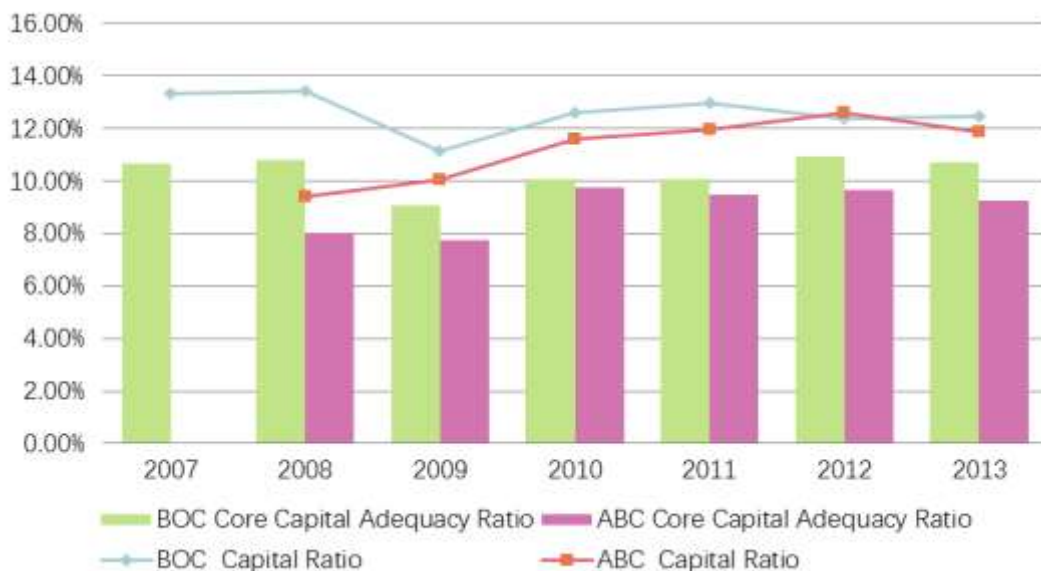


Figure 2. The CR and CCAR of BOC and ABC between 2007 and 2013

Then we move to capital ratio (CR). Figure 2 shows that the CR of BOC was almost stable except for a sudden decrease in 2009. However, it doesn't mean that the exit of BOC's foreign strategic investors didn't have any influence on the operation. Both CR and CCAR of BOC were much higher than those of ABC, but things changed after 2009. The CR of BOC couldn't back up to the peak level in 2008 and the gap between BOC and ABC was erased gradually.

To draw a conclusion, the shareholding changes after the financial crisis did have some negative influences on CR and POC, but couldn't harm the operation foundation of BOC.

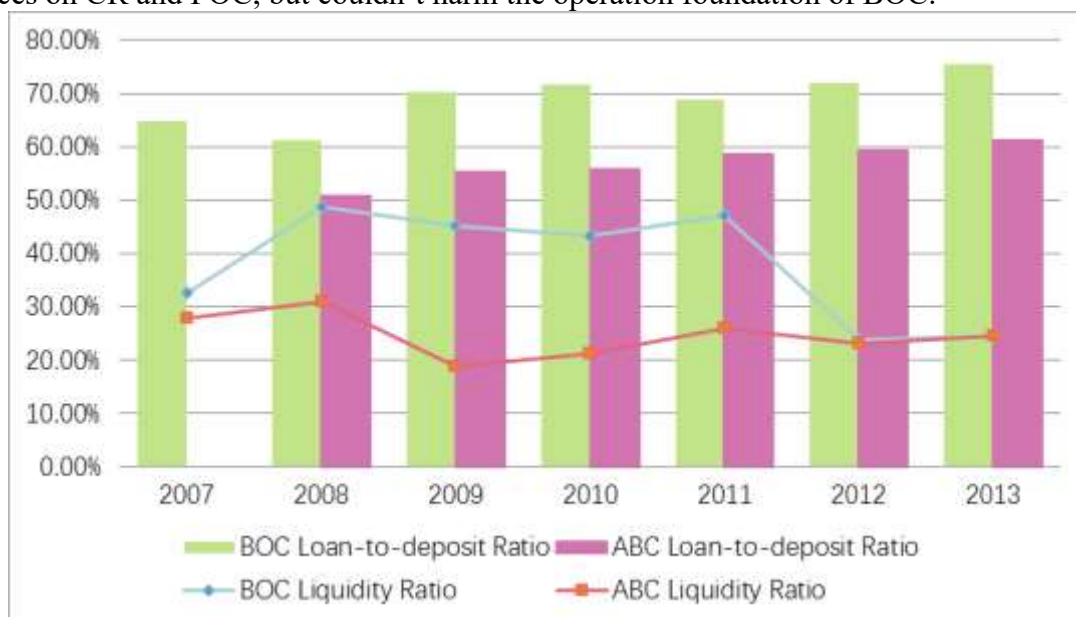


Figure 3. The LR and LDR of BOC and ABC between 2007 and 2013

When we see from the loan-to-deposit ratio (LDR), the reduction of the shareholding of foreign strategic investors didn't affect BOC a lot. But when we look this issue from liquidity ratio (LR), it is obvious that the LR of BOC had a sharp fall after 2011, and the advantage over ABC, which was

developed before 2008, started to disappear. Writer has guessed the effect of the exit of foreign strategic investors had lag effect, but it is a pity that we haven't gotten empirical evidence yet.



Figure 4. The CRR and NARR of BOC and ABC between 2007 and 2013

As far as CRR's concerned, the advantage of BOC over ABC was diminishing, along with the gradual disappear of the growing trend of BOC before 2009. This means the exit of foreign strategic investors did have a negative effect on BOC. Then we turn to look at NARR, the effect was not that obvious. The NARR of BOC has kept growing steadily with a narrowing gap of that between BOC and ABC.

Therefore, we could draw a conclusion that the shareholding changes of foreign strategic investors of BOC didn't have significant impacts on overall profitability, but weakened the innovation ability of BOC. Since the influence of innovation usually has lag effects, we may not be able to figure out its specific effect within our sample interval.

Table 2 The Shareholding of Top 10 Shareholders of BOC between 2007 and 2013

	2007	2008	2009	2010	2011	2012	2013
Central Huijin Investment Ltd.	67.49%	67.52%	67.53%	67.55%	67.60%	67.72%	67.72%
Hong Kong Securities Clearing Company Ltd.	12.15%	12.24%	24.69%	28.15%	29.13%	29.25%	29.21%
Royal Bank of Scotland	8.25%	8.25%	-	-	-	-	-
Temasek Holdings	4.13%	4.13%	-	-	-	-	-
National Social Security Fund	3.30%	3.30%	3.30%	-	-	-	-
Union Bank of Switzerland	1.33%	0.93%	-	-	-	-	-
Asian Development Bank	0.20%	0.20%	0.20%	0.18%	0.11%	-	-

According to Table 2, the shareholding of foreign strategic investors maintained unchanged about 17% before 2008 because of the restricted period. From the end of 2008 on, the lack of liquidity on international market brought by financial crisis combined with the unblock of shares of foreign strategic investors, together led to crazy sell of shares of BOC. Led by UBS, foreign strategic investors of BOC, including RBS, Temasek, etc. cashed out in merely one year, which was definitely purposed withdrawal. Though Bank of Japan took over those shares years after that, it was undeniable that there was an obvious shrink of the proportion of foreign investors' shareholding. Besides, the shareholding of Central Huijin Investment Ltd. was stable; on the other hand, Hong Kong Securities Clearing Company Ltd. was continuously increasing its stock share.

Table 3 The Board of Directors of BOC between 2007 and 2013

	2007	2008	2009	2010	2011	2012	2013
Scale	16	15	15	16	16	14	14
Non-executive foreign directors	2	1	1	1	1	1	1
Independent director	4	4	4	6	6	7	5

In terms of the structure of Board of Directors, it didn't have considerable changes after the intensive withdrawal of foreign strategic investors, except for the number of foreign strategic investors changed from 2 to 1. From the other perspective, among several directors, there were some who stayed as directors continuously, which means that the continuity of bank governance was not interrupted.

Table 4 The Board of Supervisors of BOC between 2007 and 2013

	2007	2008	2009	2010	2011	2012	2013
Scale	5	5	5	8	7	8	8
Shareholder Representative Supervisor	3	3	3	3	3	3	3
Employee Representative Supervisor	2	2	2	3	2	3	3
External Supervisor	0	0	0	2	2	2	2

Then we turn to look at the structure of Board of Supervisors. It was consist of 5 supervisors before 2009 without external supervisors. In 2009, the scale was enlarged to 8 with a newly added external supervisor. The change was apparent. On one hand, BOC focused more on external regulation; on the other hand, the larger scale of the board showed that the bank had to be more careful and cautious after the reduction of the shareholding of foreign strategic investors. The exit of foreign strategic investors reinforced the supervision of BOC, which was a positive effect to a certain degree.

3. Conclusions and Suggestions

The exit of foreign strategic investor has its advantages and disadvantages for operation and management of the Bank of China. Commercial banks should choose the object of strategic cooperation prudently, especially for foreign strategic investors. The period of blockade shall be lengthened appropriately for the foreign investment. In the context of economic globalization, the foreign interest chain is not strong. In the future, it is likely to be transformed into a competitive relationship at any time. Therefore, commercial banks should pay more attention to their own independent development so that they will not lose their initiatives when foreign strategic investor pull back.

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