

In-Depth Integrative Case 4.1

HSBC in China

Introduction

After years of negotiations, China finally acceded to the World Trade Organization (WTO) in December 2001 (see Exhibit 1). This development was a significant milestone in China's integration with the global economy. One of the most important and far-reaching consequences was the transformation of China's financial sector. China's banking, insurance, and securities industries were long due for a major overhaul, and the WTO requirements guaranteed that the liberalization of China's economy would extend to the important financial sector. China's banking sector had become a casualty of the state. Banks and other financial institutions haphazardly extended loans to state-owned enterprises (SOEs) based not on sound credit analysis but favoritism and government-directed policy. As a consequence, crippling debt from bad and underperforming loans mounted, with no effective market disciplines to rein it in.

China recognized that opening up the banking sector could bolster its financial system. Foreign management would help overhaul the banking sector and put the focus on returns, instead of promoting a social agenda. This fiscal agenda would ultimately lead to a stronger and more stable economy. Yet after years of direction from the state,

Chinese bank managers did not have the necessary skills to transform the banks on their own. Guo Shuqing, shortly after being promoted to chairman of China Construction Bank, admitted that "more than 90 percent of the bank's risk managers are unqualified."¹

Immediately upon accession to the WTO, China's banking sector began to open to foreign banks. Initially, foreign banks were allowed to conduct foreign currency business without any market access restrictions and conduct local currency business with foreign-invested enterprises and foreign individuals. In addition, the liberalization of foreign investment rules made Chinese banks attractive targets for foreign financial institutions. Sweeping domestic changes have followed. Strong emphasis has been placed on interest rate liberalization and clearer and more consistent regulation, and a frenzy of IPOs of state-owned banks has followed. It was in this context that HSBC rapidly expanded its presence in China.

HSBC, known for its international scope and careful, judicious strategy, made a series of key investments in the early 2000s that arguably gave it the most extensive position in China of any foreign financial group. These

Exhibit 1 China's WTO Commitments

General Cross-Sector Commitments

- Reforms to lower trade barriers in every sector of the economy, opening its markets to foreign companies and their exports from the first day of accession.
- Provide national treatment and improved market access to goods and services from other WTO members.
- Special rules regarding subsidies and the operation of state-owned enterprises, in light of the state's large role in China's economy.
- Undertake important changes to its legal framework, designed to add transparency and predictability to business dealings and improve the process of foreign market entry.
- Agreement to assume the obligations of more than 20 *existing* multilateral WTO agreements, covering all areas of trade.
- Under the acquired rights commitment, agreed that the conditions of ownership, operation, and scope of activities for a foreign company under any existing agreement would not be made more restrictive than they were on the date of China's accession to the WTO.
- Licensing procedures that were streamlined, transparent, and more predictable.

Commitments Specific to the Financial Services Industry

- Allow foreign banks to conduct *foreign currency business* without any market access or national treatment limitations.
- Allow foreign banks to conduct *local currency business* with foreign-invested enterprises and foreign individuals (subject to geographic restrictions).
- Banking services (with a five-year transitional plan) by foreign banks:
 - Within two years after accession, foreign banks would be able to conduct *domestic* currency business with Chinese enterprises (subject to geographic restrictions).
 - Within five years after accession, foreign banks would be able to conduct domestic currency business with Chinese individuals, and all geographic restrictions will be lifted.
 - Foreign banks also would be permitted to provide financial leasing services at the same time that Chinese banks are permitted to do so.

investments included two separate transactions that resulted in a 19.9 percent stake in both Ping An insurance and Bank of Communications, the fifth largest bank in China. HSBC had a long history in Asia and was uniquely positioned to take advantage of China's vast population and mushrooming middle class, high savings rates (in the range of 40 percent), and huge capital investments. HSBC recognized that the current banking system was not capitalizing on this vast opportunity and sought to get in on the ground floor in this new environment. Perhaps, with further liberalization, however, China would allow future investors to establish even greater claims to Chinese banks. Citigroup's successful effort to gain a controlling stake in Guandong Development Bank appeared to undermine earlier investors who had been limited by China's rule that allowed foreigners to own no more than 19.9 percent of domestic financial institutions. Did the huge potential rewards of being an early mover in China mitigate the promise of uncertainty and risks of doing business in an emerging market? After being burned in Argentina, could HSBC relax its conservative philosophy in its China strategy? If the economy took a turn for the worse, HSBC could face heavy losses. On the other hand, could HSBC afford not to be an early mover in a region where it had a longstanding presence?

Background on HSBC

History

Thomas Sutherland founded the Hongkong and Shanghai Banking Corporation (Hongkong Bank) in 1865 to finance the growing trade between Europe, India, and China. Sutherland, a Scot, was working for the Peninsular and Oriental Steam Navigation Company when he recognized a considerable demand for local banking facilities in Hong Kong and on the China coast. Hongkong Bank opened in Hong Kong in March 1865 and in Shanghai a month later.

The bank rapidly expanded by opening agencies and branches across the globe, reaching as far as Europe and North America, but maintained a distinct focus on China and the Asia-Pacific region. Hongkong Bank helped pioneer modern banking during this time in a number of countries, such as Japan, where it opened a branch in 1866 and advised the government on banking and currency, and Thailand, where it opened the country's first bank in 1888 and printed the country's first banknotes. By the 1880s, the bank issued banknotes and held government funds in Hong Kong, and also helped manage British government accounts in China, Japan, Penang, and Singapore. In 1876, the bank handled China's first public loan, and thereafter issued most of China's public loans. Hongkong Bank had become the foremost financial institution in Asia by the close of the 19th century.

After the First World War, the Hongkong Bank anticipated an expansion in its Asian markets and took a leading role in stabilizing the Chinese national currency. The tumultuous Second World War, for its part, saw most of the bank's European staff become prisoners of war to the advancing Japanese.

The Postwar Years

In the postwar years, Hongkong Bank turned to dramatic expansion through acquisitions and alliances in order to diversify. The acquisitions began with the British Bank of the Middle East (Persia and the Gulf states) and the Mercantile Bank (India and Malaya) in 1959, and were followed by acquiring a majority interest in Hong Kong's Hang Seng Bank in 1965. The 51 percent controlling interest in Hang Seng Bank was acquired during a local banking crisis for \$12.4 million. As of 2016, HSBC's interest in the bank was 62 percent and was over US\$20 billion. Hang Seng, which retained its name and management, has been a consistently strong performer. The bank made further acquisitions in the United Kingdom and Europe (from 1973), North America (from 1980), and Latin America (from 1997), as well as other Asian markets.

Under Chairman Michael Sandberg, Hongkong Bank entered the North American market with a \$314 million, 51 percent acquisition of Marine Midland, a regional bank in upstate New York. In 1987, the bank purchased the remaining 49 percent, doubling Hongkong Bank's investment and providing the bank a significant U.S. presence. As a condition of the acquisition, however, Marine Midland retained its senior management.

Move to London and Acquisitions

In 1991, Hongkong Bank reorganized as HSBC Holdings and moved its headquarters in 1993 to London from Hong Kong. Sandberg's successor, William Purves, led HSBC's purchase of the U.K.'s Midland Bank in 1992. This acquisition fortified HSBC's European presence and doubled its assets. The move also enhanced HSBC's global presence and advanced the bank's reputation as a global financial services company.

Other major acquisitions of the 1990s included Republic Bank and Safra Holdings in the United States, which doubled HSBC's private banking business; investment moves in Brazil and Argentina in 1997; and acquisition of Mexico's Bital in 2002. In 2000, HSBC acquired CCF in France. By 2006, HSBC had assets exceeding \$1,860 billion, customers numbering close to 100 million, and operations on six continents. In recent years, HSBC has made a major commitment to emerging markets, especially China and Mexico, but also Brazil, India, and smaller developing economies.

Expansion, Acquisition, and Succession

Early 1990s: The World's Local Bank

HSBC Holding Company set up a group policy in 1991 that established 11 quasi-independent banks, each a separate subsidiary with its own balance sheet. The head office provided essential functions, such as strategic planning, human resource management, and legal, administrative, and financial planning and control. This setup promoted prompter decision making at a local level and greater accountability. HSBC portrayed itself as “the world’s local bank,” recognizing the importance of globalization, flexibility, and local responsiveness.

HSBC established distinct customer groups or lines of business that overlaid existing geographic designations. This encouraged maximizing the benefits of its universal scope, such as sharing best practices of product development, management, and marketing. The geographic perspective was melded closely with a customer group perspective, demanding both global and local thinking. Traditionally, HSBC’s culture embraced caution, thrift, discipline, and risk avoidance. The bank looked at long-term survival and considered markets in 50-year views. Thrift manifested through the company, and even the chairman flew economy class on flights less than three hours.

Late 1990s: Bond’s Rein and Move to “HSBC”

Sir John Bond became CEO of HSBC in 1993 and chairman in 1998, bringing with him a hands-on entrepreneurial style and exceptionally ambitious goals. He pursued acquisitions beyond HSBC’s traditional core, in pursuit of such attractive financial segments as wealth management, investment banking, online retail financing, and consumer finance. Bond considered shareholder value and economic profit in deciding when acquisition premiums were in order, which was in contrast to his predecessor’s “three times book value” rule. By 2001, Bond had authorized investments of over \$21 billion on acquisitions and new ventures.

In 1998, Bond adopted the HSBC brand and preserved “The Hongkong & Shanghai Banking Corp.” name only for its bank based in Hong Kong. HSBC branded its subsidiary banks across the world with the parent bank’s acronym and greatly expanded marketing efforts in 2000. In March 2002, HSBC’s marketing message became “the world’s local bank,” which would help the brand become one of the world’s top 50 most recognizable brands by 2003.

2000s: Household Acquisition

In 2003, a US\$15.5 billion acquisition of Household International, the U.S. consumer lending business, became the basis of HSBC’s Consumer Finance customer group. Household utilized a unique system to forecast the

likelihood that customers would repay debt, which used a 13-year database of consumer behavior. Household was controversial and yet presented great opportunity. HSBC desired to leverage this new skill in developing countries, yet was unable to find all demographic and credit data that Household normally relies on in the United States. HSBC particularly looked to extend the Household model into China and Mexico. However, the subprime mortgage crisis hit the United States hard in 2007–2008 and had a major impact on Household operations.

Six years after acquiring Household International, HSBC effectively conceded that the deal was a mistake. In March 2009 HSBC made public that it would close all 800 remaining branches of HSBC Finance Corp., the former Household Financial, resulting in 6,100 job cuts nationwide. HSBC had already closed about 600 HFC and Beneficial branches over the past two years. “High levels of delinquency, given rising levels of unemployment, mean that the business model for subprime home equity refinancing is not sustainable,”² said Niall Booker, HSBC Finance chief executive during one of the media conferences. HSBC Finance said it would retain its credit card business, and HSBC Holdings would keep its New York-based HSBC Bank USA. HSBC officials also said that the bank would continue to help mortgage customers with loan repayments and foreclosure-prevention efforts.

The HSBC Finance (Household) executives pointed out that it was hard to predict in 2003 that the global financial crisis and the recession would occur. When the crisis hit hard in 2008, the subprime mortgage market led to more than \$1.15 trillion of credit losses and write-downs at financial institutions and government bailouts of companies ranging from Citigroup Inc. to Royal Bank of Scotland Group Plc of Edinburgh, as noted by Bloomberg analysts. HSBC was one of the first banks to acknowledge the possibility of upcoming subprime mortgage problems and set aside about \$53 billion to cover bad loans during the past three years.

2008–2009: Economic Crisis and Financial Performance

The consequences of global economic crisis were severe for the world’s banking system, prompting thousands of banks to seek financial assistance from their local government. Many banks were burdened with highly overvalued “bad loans” and suffered huge losses. Unlike many global players, HSBC reported a profit for 2008, but it still took a hit: Its pretax profit of \$9.3 billion was 62 percent below the \$24.2 billion reported for 2007. The bank also cut its dividend for the full year by 29 percent to 64 cents per share. The slide in profits was largely the result of a goodwill impairment charge of \$10.6 billion in the United States. In spite of the bitter loss in North America, HSBC performed much better in the other parts of the world. For

example, in Europe, pretax profit rose to \$10.9 billion from \$8.6 billion. Profit from Hong Kong fell to \$5.46 billion from \$7.34 billion, while earnings from the rest of Asia rose to \$6.47 billion from \$6.01 billion. HSBC is still considered one of the world's strongest banks by some measures. The bank's market value of \$68.2 billion in early 2009 ranked it behind only Industrial & Commercial Bank of China Ltd., China Construction Bank Corp., Bank of China Ltd., and JPMorgan Chase & Co.

To the credit of HSBC management, the bank avoided taking U.K. government "bailout" funding, unlike other big banks. Instead, HSBC made plans to raise £12.5 billion (\$17.9 billion) in capital to prepare for further deterioration of the global economy. Also, responding to growing public anger over the scale of bonuses paid to many senior bankers, HSBC said no performance share awards would be made for 2008 and that no executive director would receive a cash bonus.

2010s: Refocused Strategy & Divestment

In the wake of the financial crisis, HSBC took a fresh look at its expansion and operational strategies. As part of this refocusing, the company promoted Stuart Gulliver to CEO in 2011. Within months, Gulliver announced plans to decrease overhead by US\$3.5 billion, primarily through cuts to its retail banking operations in developed markets. The company formally abandoned its "World's Local Bank" philosophy, announced plans to withdraw from 20 countries, and indicated that 25,000 jobs would be cut within two years. Nearly 200 local banking branches in the U.S. were sold to First Niagara Financial Group Inc., halving HSBC's retail operations in the country. Additionally, HSBC's U.S. credit card business was sold to Capital One Financial Corp. for US\$2.6 billion. Though most downscaling of operations occurred in developed countries, targeted divestment has occurred in some emerging markets; in 2015, HSBC sold its Brazilian operations to Banco Bradesco after several years of poor performance

Managing for Growth

HSBC's strategic plan, "Managing for Growth," was launched in the early 2000s. This strategy builds on HSBC's global, international scope and seeks to grow by focusing on the key customer groups of personal financial services; consumer finance; commercial banking; corporate, investment banking, and markets; and private banking. "Managing for Growth" is intended to be "evolutionary, not revolutionary," and aims to vault HSBC to the world's leading financial services company. HSBC seeks to grow earnings over the long term, using its peers as a benchmark. It also plans to invest in delivery platforms, technology, its people, and its brand name to prop

up the future value of HSBC's stock market rating and total shareholder return. HSBC retains its core values of communication, long-term focus, ethical relationships, teamwork, prudence, creativity, high standards, ambition, customer-focused marketing, and corporate social responsibility, all with an international outlook.

Strategic Pillars

As part of the growth strategy, HSBC identified eight strategic pillars:

Brand: continue to establish HSBC and its hexagon symbol as one of the top global brands for customer experience and corporate social responsibility.

Personal Financial Services: drive growth in key markets and through appropriate channels; emerging markets are essential markets with a burgeoning demand.

Consumer Finance: offer both a wider product range and penetrate new markets, such as the emerging country markets.

Commercial Banking: leverage HSBC's international reach through effective relationship management and improved product offerings.

Corporate, Investment Banking, and Markets: accelerate growth by enhancing capital markets and advisory capabilities.

Private Banking: a focus on serving the highest value personal clients.

People: draw in, develop and motivate HSBC's people.

TSR: fulfill HSBC's TSR target by achieving strong competitive performances in earnings per share growth and efficiency.³

Focus on Emerging Markets

Back in 2000, HSBC had half of its assets in developing countries. Most earnings, however, stemmed from mature markets, such as Hong Kong and Britain. All but 5 percent of group profits came from five economies, while India and Latin America each added only 1 percent to group profit. By 2005, however, HSBC executives recognized the earnings potential of emerging markets. As then-Chairman Stephen Green noted, "There is a general rule of thumb that says the emerging markets grow faster than mature markets as economies and the financial services sector grows faster than the real economy in emerging markets because you are starting from very low penetration of financial services in general."⁴

Though cost-cutting measures enacted in the 2010s have stagnated HSBC's overall net profit before tax, the proportion of net profit earned in emerging markets has soared (see Exhibit 2). Across the board, HSBC's pretax profits in emerging markets have increased from US\$2.4 billion in 2004 to \$6.0 billion in 2014. The largest growth, by far, has come from China. Between 2004 and 2014, HSBC's profit in China jumped from

Exhibit 2 HSBC Emerging Markets**Pretax Profits 2004 vs. 2014**

Country	2004 (US\$ mil)	2014 (US\$ mil)	% Change 2004–2014
Argentina	154	384	149.4
Brazil	281	(247)	(187.9)
China	32	2,951	9,121.9
India	178	700	293.3
Indonesia	76	198	160.5
Malaysia	214	496	131.8
Mexico	774	51	(93.4)
Saudi Arabia	122	486	298.4
South Korea	89	180	102.2
Taiwan	107	221	106.5
Turkey	142	(64)	(145.1)
UAE	192	662	244.8
Total	2,361	6,018	154.9
Total profit before tax (all countries)	18,943	18,680	(1.4)

US\$32 million to nearly US\$3 billion, and the Chinese market now accounts for more than 15 percent of HSBC's total net profit before tax. Strong gains in India are also noteworthy, with profits increasing by more than 200 percent.

Liberalization of China's Banking Sector**China's Banking Sector Pre-WTO**

Before the WTO accession negotiations, China's banking industry operated as a cog in China's centrally planned economy. The state commercial banks performed a social function, during China's post-Mao drive to industrialize, instead of operating for economic return. Consequently, the banks adhered to directed lending practices from the government and in turn created some of China's most successful enterprises, but also supported thousands of other inefficient and unprofitable state-owned enterprises. This practice left state commercial banks with massive amounts of debt that were largely unrecoverable and hordes of non-performing loans.

In addition to widespread losses, instability ensued in the banking system overall. To make matters worse, corruption and mismanagement ran rampant throughout the sector, sapping away consumer and investor confidence.

WTO Accession

Following 15 years of negotiation and two decades of economic reform in China, December 11, 2001, marked China's accession to the World Trade Organization. The main objective of the WTO agreement was to open China's market up to foreign competition. The deadline for complete implementation was December 11, 2006.

China made a number of implementations immediately. To begin with, foreign banks were allowed to conduct foreign currency business without any market access restrictions. Also, foreign banks were allowed to conduct local currency business with foreign-invested enterprises and foreign individuals (with geographic restrictions). Within two years of accession, China agreed to allow foreign banks to conduct domestic currency business with Chinese enterprises (geographic restrictions). Within five years, foreign banks could conduct domestic currency business with Chinese individuals (no geographic restrictions); and foreign banks were able to provide financial leasing services at the same time as Chinese banks. Under the WTO investment provisions, China agreed to allow foreign ownership of Chinese banks (up to 25 percent), with no single foreign investor permitted to own more than 20 percent.

"Bank reform has become the most crucial task for the government in pushing forward economic reforms,"⁵ said Yi Xianrong, an economist at the Chinese Academy of Social Sciences in Beijing. Indeed, bank reform is critical to stabilizing and advancing the Chinese economy.

Domestic Reform

China has undertaken a number of domestic reforms in order to overhaul the banking industry. China has engaged in interest rate liberalization by removing certain interest rate and price controls. Instead of being pegged to the U.S. dollar, as it once was, China's currency exchange rate is now pegged to within 0.3 percent of a basket of currencies, dominated by a group including the U.S. dollar, euro, Japanese yen, South Korean won, British pound, Thai baht, and Russian ruble. Throughout the 2000s, analysts estimated that the yuan was undervalued, leading to complaints from the international community. However, most experts believed that the currency was no longer undervalued by mid-2015.

Regulation has long been a concern in the Chinese banking industry. China has made major progress by creating regulatory agencies. In 2003, China created a central regulator, the China Banking Regulatory Commission (CBRC), out of the central bank. The regulator's 20,000 staff members endeavor to shift the banks' focus from senseless loans and growth mind-sets to a goal of preserving capital and generating returns.

Concurrently, China is striving to make regulatory and reporting requirements more clear because they have often proved confusing barriers to foreign investment. Since 1998, China has intensified accounting, prudential, and regulatory standards. Prior to 1998, the banks booked interest income for up to three years even if it was not being paid. Now, the banks can do so for only 90 days, which is the international norm. Still, it

has been all too common for Chinese banks to ignore regulations and not monitor loans. As a result of poor accounting, the banks themselves are sometimes unsure of their bad loans. Lai Xiaomin, head of the CBRC's Beijing office, admits that "when our banks disclose information, they don't always do so in a totally honest manner."⁶ Indeed, the lack of reliable accounting can hamper investment. As one Hong Kong investor put it, "When you take a state-owned enterprise that has had weak internal controls, it can be enormously labor-intensive to come up with financials we can work with."⁷ In 2006, regulators overhauled the system in which almost one-third of a company's shares were "nontradable." Fixing this problem has helped energize the market and welcome in individual investors.

New regulations, it is hoped, will address China's history of dishonesty and embezzlement. With the tight connection of Chinese banks with local governments, corruption has choked the Chinese banking system. As of 2016, most of China's commercial banks have introduced better governance, shareholding, and incentive structures, while also adding independent directors to their boards. Foreign management and knowledge are intended to flush the Chinese banking system with managerial talent. To help encourage foreign banks, China is relaxing some foreign bank restrictions. The Chinese

government has also taken steps to eliminate bad loans by bailing out banks.

IPO Explosion

Over the last 15 years, China has aggressively pursued IPOs of state-owned banks, a policy that has been met with a strong response from investors eager to tap into the populous country and seize first-mover advantages (see Exhibit 3). HSBC's purchase of a 19.9 percent stake in Bank of Communications (BoCOM) in June 2004 was the pioneering, substantial foreign bank investment in China. In 2005, the listing of the Industrial and Commercial Bank of China on the Shanghai and Hong Kong Stock Exchanges resulted in the then-largest IPO in history. Bank of America invested heavily in China Construction Bank between 2005 and 2013, and the Royal Bank of Scotland, Temasek, and UBS all made significant investments in the Bank of China. In 2010, the IPO of the Agricultural Bank of China raised over US\$22 billion, surpassing the record set by the Industrial and Commercial Bank of China.

The central bank expects foreigners to bring much-needed improvements to the state banks' risk-management and internal control systems, including credit-risk assessment and more transparent reporting. With capital

Exhibit 3 Early Foreign Bank Investments in China

PRC Bank	Foreign Partner	% Stake	Price	Date
Bank of Shanghai	HSBC	8.00	\$62.6 m	12/2001
	IFC	7.00	\$25.0 m	
	Shanghai Commercial Bank (HK)	3.00	\$15.7 m	
Shanghai Pudong Dev. Bank	Citigroup	4.62	\$72.0 m	12/2003
Fujian Asian Bank	HSBC	50.00	Less than \$20 m	12/2003
Bank of Communications	HSBC	19.90	\$1.75 b	6/2004
Xian CCB	Scotia Bank	12.4	\$3.2 m	10/2004
Jinan City CCB	Commonwealth Bank of Australia	11.0	\$17 m ¹	11/2004
Shenzhen Dev. Bank	Newbridge Capital	17.9	\$1.23 b	12/2004
Minsheng Bank	Temasek	4.9		1/2005
Hangzhou CCB	Commonwealth Bank of Australia	19.90	\$78.0 m	4/2005
China Construction Bank	Bank of America	9.00	\$3.0 b	6/2005
	Temasek	5.1	\$1.5 m ²	
Bank of China	Royal Bank of Scotland	5.00	\$3.1 b	8/2005
	UBS	1.6	\$500 m ³	9/2005
	Temasek	10.00	\$3.1 b ⁴	9/2005
Industrial Commercial BOC	Goldman, Allianz, AmEx			8/2005
Nanjing CCB	BNP Paribas	19.20	\$27.0 m	10/2005
Hua Xia Bank	Deutsche Bank	9.9	\$329 m ⁵	10/2005
	Sal. Oppenheim Jr.	4.1		
Bank of Beijing	ING	19.90	\$214 m	3/2005

¹Guonan Ma, "Sharing China's Bank Restructuring," *China and World Economy* 14, no. 3 (2006), p. 8.

²David Lague and Donald Greenlees, "China's Troubled Banks Lure Investors," *International Herald Tribune*, September 9, 2005.

³UBS to Invest \$500 Million in Bank of China," *NBC News*, September 27, 2005, http://www.nbcnews.com/id/9501208/ns/business-world_business/, assessed October 4, 2006.

⁴Luo Jun and Xiao Yu, "Temasek to Buy 10% of China Bank," *International Herald Tribune*, September 1, 2005.

⁵Deutsche Bank Seals Chinese Deal," *BBC News*, October 17, 2005, news.bbc.co.uk/2/hi/business/4348560.stm, accessed October 4, 2006.

allocated more efficiently, a more stable financial system will follow, and the economy will become more open to foreign competition.

Two Steps Forward

Pulling back from some of its commitments, China indirectly delayed the implementation of its WTO commitments. On February 1, 2002, the People's Bank of China (PBOC) issued regulations and implementation rules governing foreign-funded banks. While these measures met the commitments of the WTO agreement, the PBOC was taking a very conservative approach in opening up the banking sector. For example, foreign-funded banks could open only one branch every 12 months.

In the wake of these early obstacles, there have been positive changes. Capital requirements were reduced, additional cities were opened up to foreign banking, and the "one branch every 12 months" restriction was lifted. Central bank officials have indicated willingness to eventually elevate the foreign ownership limit above the current 25 percent, but experts doubt it will ever go beyond 50 percent. In January 2007, China opened its financial sector to foreign investors, which was one of its last WTO membership commitments. Under the new rules, foreign banks in China finally have the opportunity to offer services in the local currency—yuan—which was previously prohibited.

Capital is still mostly allocated to state-owned enterprises even though private companies have been China's growth engine. Private companies produce 52 percent of GDP in China, but only account for 27 percent of outstanding loans. By sinking money into state-owned enterprises, China's banks are dragging the economy. China's banks had difficulty lending to private companies in the past because of challenges related to gathering and processing the necessary information on them. As a response, China launched its first national credit bureau in early 2006. By 2014, more than 60 percent of China's population had credit history records maintained by the national credit bureau. China's banks have been satisfying a social role but now must allocate capital efficiently in order to generate positive economic return.

Investments in Ping An and BoCOM

With its longstanding presence in China, HSBC was among the best-positioned financial institutions to take advantage of China's market opening.

Ping An Insurance: 2002–2013

In October 2002, HSBC announced that it had taken a 10 percent stake in Ping An Insurance, China's second largest insurer, for \$600 million, and in May 2005, HSBC

indicated it was investing an additional HK\$8.1 billion (US\$1.04 billion) for an additional 9.91 percent stake in Ping An, doubling its holding in the number-two life insurer. HSBC paid HK\$13.20 a share for the stakes held by investment banks Goldman Sachs and Morgan Stanley, lifting HSBC's holding to 19.9 percent, the maximum stake allowed by a single foreign investor.

"This is good news for Ping An," said Kenneth Lee, an analyst at Daiwa Institute of Research. "HSBC is buying at a premium and is replacing Goldman Sachs and Morgan Stanley, which are venture capital investors. HSBC is a long-term investor and will help Ping An to develop its insurance platform," he said.

The investments proved to be rewarding for HSBC. In 2011, China's insurance market reported an 18.5 percent increase in premium income as compared to 2010. Total premium income in China experienced a 5.3 percent increase during this same time period. In 2013, HSBC sold its stake in Ping An for a US\$2.6 billion profit.

The BoCOM Deal

HSBC invested \$1.8 billion for a 19.9 percent stake in BoCOM in June 2004. HSBC's chairman at the time, Sir John Bond, commented on the company's long-term perspective: "[I]t is inevitable that China will become a superpower. And indeed, desirable. And we are positioning our business for the decades ahead accordingly."⁸ HSBC wanted a piece of the alluring Chinese market, which Goldman Sachs predicts will overtake the United States as the number-one economy in the world by 2040, and wanted to deepen its international scope in line with the "Managing for Growth" strategy.

Speaking one month after HSBC's big move, then-CEO and future chair Stephen Green expounded upon China: "[T]he potential in China's domestic market is the largest in history." China is the "world's manufacturer," and as the population continues to urbanize and industrialize, it increasingly has more disposable income, the workers become greater consumers, and the middle class expands. China has one of the world's highest savings rates, at around 40 percent, and already has around one-third of the \$1.2 trillion of central bank foreign exchange reserves sitting in Asia. Further, access to capital is not a problem, as foreign direct investment (FDI) floods the country. The challenge facing China is to recycle and invest its pool of savings efficiently.

HSBC recognized the huge potential in the market for banking services, as well as credit cards. As part of its emerging market strategy, HSBC wanted to feed the demand for credit cards in these markets. Green commented: "[O]ur joint venture with Bank of Communications for credit cards is one which we think has a lot of

exciting prospects. Bank of Communications has over 30 million debit cards in issue. Over time, a proportion of those is going to convert to credit cards. And we are issuing co-branded credit cards with the Bank of Communications.”⁹ HSBC saw an opportunity to shepherd millions of new people into the banking system.

HSBC’s Green acquiesced that emerging markets do carry risk. This risk was starkly evident during the HSBC debacle in Argentina during the country’s economic crisis. China’s epic turnaround could conceivably flop, and heavily invested banks could pay dearly. The banking system in China was and is very fragile. Would China’s banks be able to break away from state-directed lending and its lasting effects? The banks further rely on the continued acceleration of the economy, and many rely on volatile real estate loans. HSBC recognized other challenges for China, including the need to strengthen regulations, build social security, stem corruption, and fortify the financial system.

HSBC’s holdings in BoCOM, which are among the largest by a foreign bank in China, have posted mixed results over the last ten years. In 2015, BoCOM’s listings on the Hong Kong stock exchange dropped more than 11 percent. In reaction, BoCOM announced that it would allow HSBC greater control in decision making, including the appointment of a new vice chair.

Recent Developments and Future Competitive Conditions

Current Strategies in China

Foreign banks that operate in China have different strategies. Some of them have purchased smaller stakes of Chinese financial institutions, while some prefer to buy a bigger stake of a small bank. Nevertheless, they all want to be in China. The best strategy, in theory, has turned out to be with a local partner. Bob Edgar, senior managing director at Australia and New Zealand Banking Group Ltd., said that “it would be very difficult to go into a market like that and undertake the cost of establishing a branch network, getting a customer base of hundreds of thousands if not millions of customers. That already exists, so why would we want to set it up again?”¹⁰

Many foreign banks, however, experience difficulties when working with a local partner. The credit standards are not as strict as they should be, and there is still endemic corruption at different levels. In addition, the partners gain influence in the foreign bank. This is the reason why HSBC has decided to invest “outside the Big Four”: so it would have bigger control in operations. Peter Wong, executive director of HSBC’s Hong Kong and Mainland China operations, has commented: “[T]he state-owned banks would be too big.” So only the future will tell what is the best strategy.

The competition in China’s banking industry is continuing to grow. Recently, foreign banks have increasingly turned to joint ventures as a strategy for increasing investment in China. In 2011, Morgan Stanley formed a joint venture with Huaxin Securities Co. Ltd. to facilitate expansion into China. Morgan Stanley owns a third of the venture, while Huaxin Securities maintains two-thirds control. The deal gives Morgan Stanley the ability to underwrite and trade bonds. UBS, Goldman Sachs, Royal Bank of Scotland, and Deutsche Bank have formed similar joint ventures in recent years, with the foreign bank maintaining a minority share while the domestic partner holds the majority position.

When it comes to utilizing joint ventures as a way to increase investment in mainland China, HSBC has lagged behind its peers. In 2015, HSBC finally announced its first securities joint venture in China, with Shenzhen Qianhai Financial Holdings as its local partner. The delay, however, may have proved beneficial; unlike most other foreign banks with joint ventures in China, HSBC was able to secure a majority share of the deal.

Shifting towards Asian Operations

Despite the mixed performance results over the last several years with its BoCOM joint venture, HSBC shows no signs of scaling back its operations in China. In fact, CEO Stuart Gulliver announced plans to do just the opposite in 2015. While the abandonment of the “World’s Local Bank” strategy resulted in job cuts and branch closings in many developed markets, Gulliver stated that HSBC was planning to hire more than 25,000 new employees in the Asian region in the coming years.

Much of HSBC’s future profitability appears to hinge on China and other Asian markets. In 2015, European and North American holdings accounted for 30 percent and 15 percent of HSBC’s assets, respectively, but only 3 percent and 8 percent of net profits before tax. Additionally, future growth prospects in those regions appear bleak. In both Europe and the United States, revenues have remained stagnated for several years. Conversely, 40 percent of HSBC’s assets were located in Asian markets by 2015. These markets, growing at 7 percent annually, accounted for 78 percent of net profits before tax.

While HSBC only had 200 branches and a deposit base of US\$40 billion in mainland China as of 2015, GDP growth projections indicate that the Guangdong province will be the largest banking center worldwide by 2025. HSBC’s strategy for future investment in the Guangdong area, and specifically in Shenzhen, is dependent on increasingly liberal banking reforms by the Chinese government. As of 2015, China was still

heavily regulating the opening of new branches, which, if it remains unchanged, could hinder HSBC's expansion plans.

HSBC's Expansion in Vietnam and Taiwan

HSBC has found success in other Asian markets over the last decade. In 2009, HSBC won approval from the Vietnamese government to become the first foreign bank to set up a locally incorporated entity. New laws that have helped open Vietnam's banking sector to foreign companies were introduced as part of the communist country's inclusion in the World Trade Organization. The change in legal status in Vietnam has made it easier for HSBC's local operations to set up branches across the country. That year, HSBC hired more than 400 additional staff in Vietnam in anticipation of its expansion. This has brought the number of staff members there to more than 1,000. In Vietnam, HSBC also owns 10 percent of Bao Viet Holdings, an insurance company, and 20 percent of Vietnam Technological & Commercial Joint Stock Bank, or Techcombank. In 2015, HSBC was named both Best Foreign Investment Bank in Vietnam and Best Foreign Commercial Bank in Vietnam by FinanceAsia.

Similarly, in 2009 HSBC was the first bank to incorporate locally within Taiwan. Growth has been slow but steady; by 2015, HSBC was operating 40 branches throughout the island, with half of those located in Taipei. HSBC has incorporated various corporate sustainability initiatives into its Taiwan operations, including donating to various educational and

environmental charities. In 2015, HSBC received Taiwan's Excellence in Corporate Social Responsibility award for its efforts.

Future Competitive Conditions

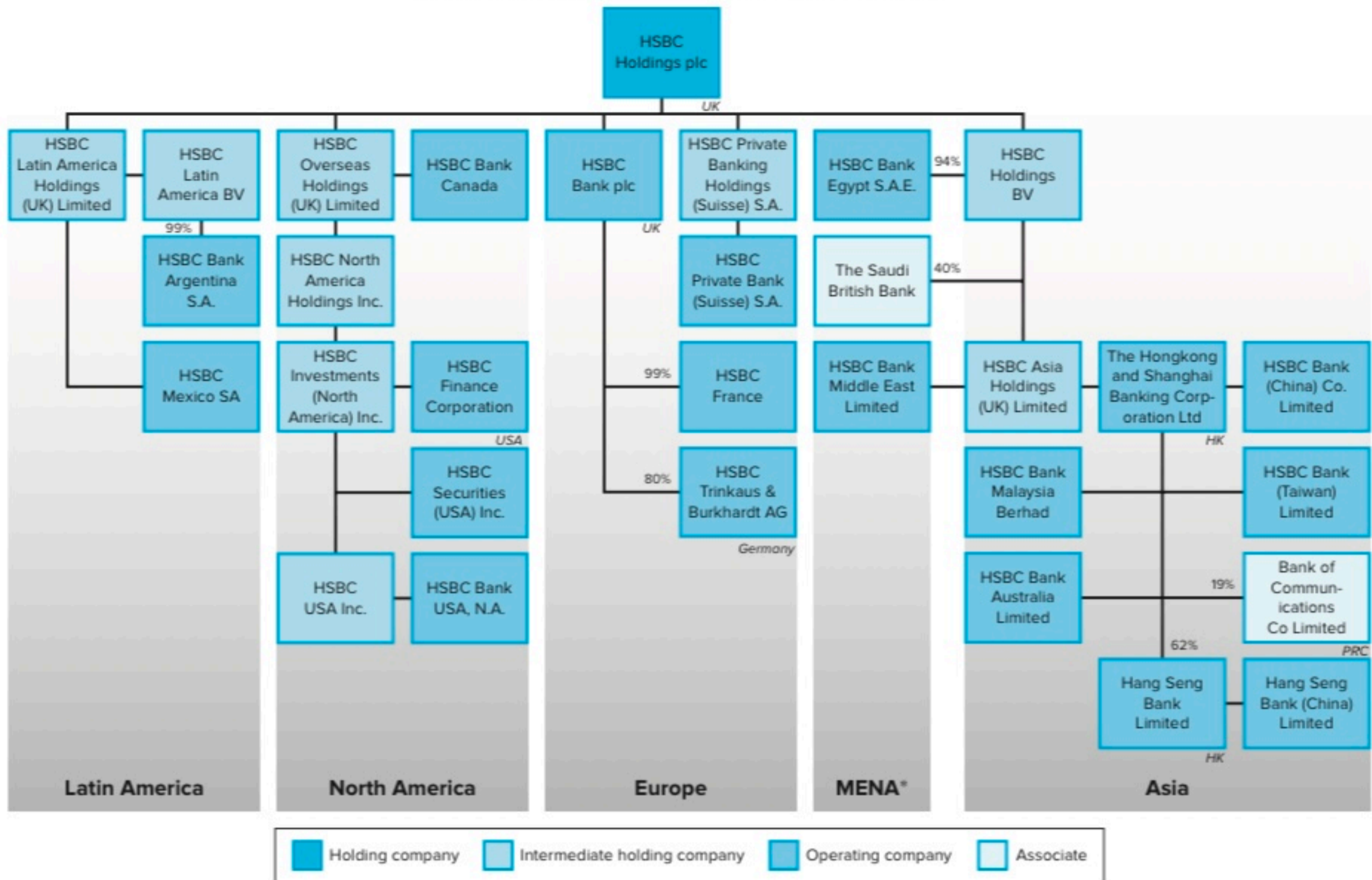
Despite the economic crisis, there were several geographical regions that did not fall into economic recession in the 2008–2010 period. China, foremost, experienced strong economic growth throughout this period. China's gross domestic product expanded 10.7 percent in the fourth quarter of 2009, bringing full-year growth to 8.7 percent. That came in above the government's targeted 8 percent growth and well above many economists' estimates. China officially surpassed Japan as the world's second-largest economy in mid 2010. The growth numbers demonstrate that Beijing's stimulus program—a response to the global economic slowdown that focused on massive bank lending and public investments in infrastructure—helped avert an economic slowdown. However, as the developed world has begun to recover and economies like the United States, Germany, and the United Kingdom have seen modest gain in GDP growth, China has shown signs of a significant slowdown. By 2015, China's growth rate had slipped to less than 7 percent.

In 2014, China surpassed the United States to become the largest recipient of FDI worldwide. More than US\$128 billion in investments flowed into China in 2014 alone. Despite the economic slowdown that China is experiencing, FDI inflows continue to increase year over year.



Note: As of end-April 2009 (excluding representative offices, administrative offices, etc.)

HSBC group structure chart as of December 2015



*Middle East and North Africa

Source: "Simplified Structure Chart: Principal Entities," *The HSBC Group*, <http://www.hsbc.com/about-hsbc/structure-and-network>.

Exhibit 4 Top 10 Banks in China, Ranked by Tier 1 Capital in 2014

Rank	Bank	Tier 1 Capital	Assets	Rank (by Assets)	Foreign Bank Shareholder
1	ICBC	207,614	3,100,254	1	
2	China Construction Bank	173,992	2,517,734	2	
3	Bank of China	149,729	2,273,730	4	
4	Agricultural Bank of China	137,410	2,386,447	3	
5	Bank of Communications	68,333	976,882	5	HSBC
6	China Merchants Bank	41,690	658,210	7	
7	China Citic Bank	37,427	596,721	10	BBVA
8	Shanghai Pudong Development Bank	34,042	603,101	8	
9	China Minsheng Bank	33,232	528,714	11	
10	Industrial Bank	32,965	602,661	9	Hang Seng Bank

Source: Ernst & Young, *Future Directions for Foreign Banks in China* (2014), Appendix C.

HSBC's future development will depend heavily on two things. First, the competition will play a major role in HSBC's strategy. HSBC competitors are aggressively seeking opportunities in China, and HSBC has to

constantly work to maintain and expand its market position. Second, HSBC's success will depend on the opportunities that the company sees in the other emerging markets of the world.

HSBC's Current China Strategy

HSBC's strategy in China is carried out by its 100 percent subsidiary HSBC Bank (China) Company Limited. As of 2016 HSBC Bank (China) was a network of more than 170 bank outlets (branches and sub-branches) with 6,000 employees spread across 50 cities. At this time HSBC had the largest and most geographically widespread network of banks in mainland China compared to other foreign banks operating in China.

In its attempt to mitigate the negative impact of economic crisis and strengthen its competitive position, HSBC took several measures to redefine and clarify its strategies for the nearest future. China was identified to be the center of the Group's emerging markets strategy. HSBC has formally defined its strategy for China as follows: "To be the leading foreign bank in China in terms of market share and profitability, and deliver significant offshore China-related business to the Group."

HSBC has identified key priorities aimed at achieving its strategic goals for China:

1. *International connectivity*—Connect its Chinese operations with the rest of HSBC Group's operations. This includes maintaining Chinese-dedicated desks in overseas offices and creating foreign representative positions within China.
2. *RMB internationalization*—Become the leading bank for RMB globally. Currently, more than 150 countries are doing business with RMB, with France, Singapore, and the U.K. leading the way.
3. *Network and presence*—Use network leadership to maintain a strong presence in the market.
4. *Capabilities and licenses*—Maintain product leadership in China, when compared to other foreign banks operating in the country.
5. *People*—Hire and retain the best employees, and leverage those employees as a resource for business growth and organizational effectiveness.
6. *Strategic partners*—Maintain and build strong strategic partnerships and facilitate business cooperation.

HSBC Group's Overall Current Strategy

HSBC Group's overall international strategy has evolved in the years since the global recession. As of 2016, the overall company strategy is currently designed around two global trends:

First, HSBC plans to focus on growing markets in Asia, Latin America, Africa, and the Middle East. Due to demographic shifts and increasing urbanization, those emerging markets are predicted to increase by 400 percent by 2050, providing a large consumer base that could potentially become retail banking customers. To maximize return, HSBC plans to focus on wealth management across these regions, but only enter retail banking in locations where there are enough middle-class consumers to return a profit.

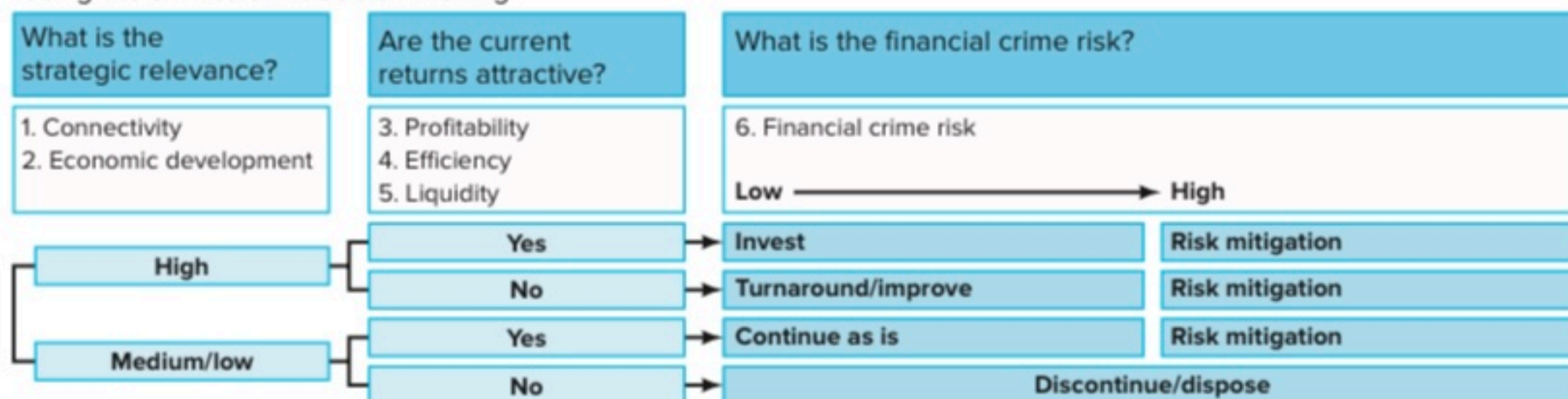
Second, HSBC plans to take advantage of increasing international trade and cross-border capital flows. To achieve this, HSBC aims to reach small- to medium-sized multinational enterprises from a variety of home countries, build loyalty with these companies, and then continue to serve these companies as they grow from smaller startups to large conglomerates.

To decide where to expand and invest, HSBC has developed a decision-making framework. The framework evaluates the relevance, the quality of the returns, and the risk of financial crime to determine whether HSBC should increase investment, improve its operations, or withdraw from the market.

2016 and Beyond

Despite HSBC's slimming of operations around the globe in an effort to cut costs, HSBC has reaffirmed its future plans for growth in the Chinese market. In late 2015, HSBC announced plans to add over 3,000 employees to the Pearl River Delta region in an effort to increase its retail banking business. The boost is aimed at increasing HSBC's pretax profits in the region by a factor of 10 by the year 2020. The Pearl River Delta, which includes the cities of Shenzhen and Foshan, includes a rapidly expanding middle-class population that could serve as future HSBC retail banking customers.

Using the six filters in decision-making



HSBC Decision-Making Framework

Source: HSBC, *Strategic Report 2014* (February 2015), <http://www.hsbc.com/our-approach/reports-and-documentation>.

The bank is also working toward being one of mainland China's first foreign-listed companies to tap into the country's liquidity and to raise its overall profile there. Credit card usage has been increasing rapidly within the country, with nearly 500 million credit cards issued by the end of 2015. HSBC has moved to grab a larger share of this growing market. Between 2004 and 2016, HSBC and Bank of Communications co-issued over 40 million co-branded credit cards in China. In early 2016, HSBC was granted approval to begin issuing credit cards on its own, effectively ending the credit card portion of its joint venture and allowing HSBC to take complete control over its credit card operations.

HSBC's China experience has been one of steady and consistent expansion and success. While there have been some setbacks, its overall approach, emphasizing close collaboration with the Chinese government and local partners, reliance on local staff and talent, and its overall shift in global strategy from developed to emerging markets, has served it well.

Questions for Review

1. How has HSBC adapted its global strategy to operate in China, both before and after China's WTO accession?
2. Discuss HSBC's strategy for entering and operating in other emerging markets. Where has it found success, and where has it faced setbacks? Why?
3. What are the pros and cons of HSBC's "Managing for Growth" strategy?
4. How did HSBC withstand the world economic crisis? Was HSBC's position weakened or strengthened as result of the crisis? How did HSBC alter its strategy in the wake of the recession?
5. What are some changing economic factors that HSBC will need to take into consideration in the coming years?

Exercise

HSBC is considering asking the government of China (China Banking Regulatory Commission—CBRC) to allow it to increase its stake in BoCom above the limit currently in place (25% total foreign ownership; 20% for an individual foreign investor). Break into four groups:

1. HSBC
2. BoCom
3. Citibank
4. CBRC

Groups 1–3 should prepare a 5-minute presentation on whether the government of China should grant the request and, if so, what the ownership limit should be (30%? 50%?) and whether it should be extended to other foreign financial institutions (e.g., Citibank). Then, Group 4 should discuss the question and report its decision.

Source: This case was prepared by Jonathan Doh of Villanova University as the basis for class discussion. Additional research assistance was provided by Courtney Asher, Elizabeth Stewart, Tetyana Azarova, and Ben Littell. It is not intended to illustrate either effective or ineffective managerial capability or administrative responsibility.

ENDNOTES

1. "China's Banking Industry: A Great Big Banking Gamble," *The Economist*, October 25, 2005.
2. Becky Yerak, "HSBC Plans to Close Household Financial, Beneficial Consumer Loan Units," *Chicago Tribune*, March 3, 2009, http://articles.chicagotribune.com/2009-03-03/news/0903021009_1_hsbh-holdings-plc-hsbc-bank-usa-household-international.
3. "Our Strategy," *HSBC*, www.hsbc.com/about-hsbc/our-strategy.
4. Carrick Mollenkamp, "HSBC CEO Discusses the Bank's Expansion Plans," *The Wall Street Journal*, October 23, 2005.
5. Peter S. Goodman, "China Approves Plan for Huge Bank IPO," *Washington Post*, July 20, 2006, p. D5.
6. "China's Banking Industry: A Great Big Banking Gamble."
7. Barney Jopson, "China Struggles to Overcome Shortage of Good Accountants," *Financial Times*, June 6, 2006, p. 11.
8. Sir John Bond, "China: The Re-emergence of the Middle Kingdom," *Speech*, July 19, 2005.
9. Carrick Mollenkamp, "HSBC Plans Push in Emerging Markets," *The Wall Street Journal*, October 24, 2005.
10. K. C. Swanson, "Buying into China's Banks," *Corporate Dealmaker*, September–October 2006, p. 18.