Nick Kochan
Investigative journalist & freelance writer

079 7329 7490
author@kochan.co.uk

China's clampdown

China is in the sway of a regulatory and compliance clampdown which is set to stiffen standards for banks operating in the region. At the same time, it will give foreign investors placing their money in China and Hong Kong greater confidence in the region's integrity and in the standards of its financial compliance.

Evidence for the clampdown is the country's urgent efforts to produce a law covering money laundering and terrorist financing. This is set for publication this Summer and will enable China to qualify for membership of the Financial Action Task Force. This international agency establishes guidelines for compliance with anti-money laundering and anti-terrorist financing standards. Sources at the Paris-based FATF said that the timing of China's membership of the organization had yet to be decided but the 'best guess' was February 2006. China has observer status at the FATF and is a member, along with Russia, of the Eurasian group of regulators.

China has also recently disclosed that is planning to beef up its range of fraud offences. Liu Mingkang, the chairman of the China Banking Regulatory Commission recently said that 'the cost of doing evil things is too low in China.' He envisaged substantial changes in the law government the regulation of local banks.

The integrity of China's financial system has long concerned foreign bankers and investors, says Peter Gallo, a Hong-Kong based financial and compliance consultant. 'The Chinese government admit they are losing $1m every five minutes in bank fraud, tax evasion and capital flight through Hong Kong. That amount to $25 billion over the course of a year and 85% of that is derived from corruption. This is a strategically sensitive problem in China, because it is undermining the ability of the central government to run the country effectively and efficiently. But it also creates instability for international investors seeking to do business here.'

The imposition of international standards will be crucial to China's success in its struggle with financial crime. Gallo: 'It is a strategic win-win situation as far as the government and the industry is concerned. The change process that the banking sector is currently going through in China will continue, and that the number of executives dismissed from senior positions and prosecuted will continue to rise.'

Chinese regulators have already put a scythe through some corrupt lawyers of the banking system. The Chief Executive of the Bank of China, Hong Kong, (BOCHK) was replaced in late May 2003 after the investigation into suspicious loan arrangements made in Shanghai. More recently, the BOCHK suspended two Deputy Chief Executives and a former General Manager following investigations by mainland authorities into the alleged misappropriation of bank funds. BOCHK is headquartered in Hong Kong and is one of Hong Kong's best-regulated banks. Its governance is particularly sensitive as it is quoted on the local exchange and has a subsidiary role as the issuer of banknotes on behalf of the local government.

The need to clean up fraud and corruption within the local banking system is heightened by China's accession to membership of the World Trade Organization. This will require the country to admit international banks into the local market from 2007. Observers says that local wealthy Chinese will be tempted to transfer deposits from local, largely state-owned institutions into foreign banks which

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have signed up to international standards of compliance. The international banks spearheading the battle for a foothold in the mainland Chinese market are Hong Kong and Shanghai Bank and Royal Bank of Scotland.

Compliance will be a key factor in Chinese banks' competitiveness, says Nigel Morris-Cotterill, a banking consultant based in Kuala Lumpur. He said that he has warned the president of China's second largest bank, that he needed to smarten up his bank's compliance performance if it expected to win the battle for local Chinese wealth. 'If you fall short of the highest international standards, your business will be increasingly difficult. When foreign banks set up here, you will find that your high quality business will flow to foreign banks... If the local banks are not subject to the same system of compliance as the international banks, they will be put at a considerable disadvantage in obtaining good business.'

Local banks have responded to this international threat into a most dramatic way, says Morris-Cotterill. ''Compliance is racing ahead, and has been over the last three years.' He says that the regulatory departments are 'making huge strides' with top management imposing its will on local bank officials who may have strayed or been suspected of corruption. 'The pace of change is much faster and more radical than anything a Western financial organization could contemplate.' This change does not appear to have stretched to training in anti-money laundering systems. Peter Gallo says that 'most institutions give employees just one hour's teaching a year into the basic laws and consider that sufficient. In fact, it is quite inadequate.'

Gallo argues that Chinese regulators may seek to use anti-money laundering rules, now being developed in new legislation, to obstruct foreign banks' efforts to pitch for local business. 'The retail banking sector is still so inefficient that local banks will be eaten alive by international banks. So they will look for a third party excuse to limit the inroads made by international banks. They could impose anti-money laundering regulations in such a way that it becomes almost impossible to open a new bank account in one of the foreign banks in China. The local banks already have 300 million bank account holders, so they will be protected. But the new banks coming in will be badly hit. The Government wants to stop the migration from state bank to foreign bank.'

Although the WTO rules require the Chinese government to have a system in place to handle requests from international banks for a licence to operate on the mainland, local regulators hold discretion over the issuing of licences. International banks will examine carefully criteria used by the authorities in the issuing of banking licences.

The siren voice of protectionism was heard when a local government official recently indicated that the government might introduce some measures to protect their state-owned banks. He called publicly for measures to limit 'excessive competition' from foreign lenders. Foreign bank holdings are already limited to two equity stakes in local banks.

The purge on bank corruption is likely to intensify in Hong Kong in particular in a wake of mainland banking scandals. Funds were disguised through a myriad of Hong Kong bank accounts and Hong Kong based offshore companies before they were transferred to major onshore centres. Over the course of the last year, investigations revealed that tens of millions of dollars had been stolen from a host of Chinese banks. The perpetrators were largely managers working for the banks, who were using their knowledge of the banks systems. Liu Mingkang said that the scandals were a reflection of the historic burden of a poor legal system, something that the China Banking Regulatory Commission was trying to redress. 'There is a big gap, indeed no connection between the civil system and the rest

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of the legal system. We keep discussing with judicial houses about to change the law and give greater penalties.'

Tighter controls on financial crime have already started to deter crooks and corrupt officials from using the local banking system, says Morris-Cotterill. 'A foreign company will commission the joint venture company to negotiate contracts and make payments within China. But the profits will be retained within the joint venture company which is outside China. It acts as an intermediary and enables the corrupt parties to avoid putting money through the Chinese banking system.'

While international banks will fight hard for a share of China's burgeoning domestic wealth, Cotterill-Morris advises them to examine carefully the money's provenance. 'This is a market that everyone is rushing into. Foreign banks must be careful in case they race ahead of prudence and get their fingers badly burnt. There is a large quantity of dirty Chinese money, presently in local banks, which will seek the homes in Western banks. They will take it at their peril.'