FOREIGN BANKS IN CHINA:
CRITICAL SUCCESS FACTORS AND LESSONS LEARNT

Ramin Cooper Maysami*, PhD, CFP
University of North Carolina at Pembroke

and

Victor Bahhouth, DBA, CPA
University of North Carolina at Pembroke

ABSTRACT

This article comprises an in-depth study of the Chinese business environment for foreign financial services institutions. It seeks to assess the significance and the contribution of economic, competitive, regulatory and environmental parameters in the Chinese banking system. The authors focus on the specific demands, challenges and opportunities of foreign financial institutions (FFIs). Analysing the recent trends and opportunities, the article focuses on Shanghai’s importance as a prospective international finance centre. It concludes with recommendations for foreign banks and an outlook for future prospects of Shanghai’s financial services environment.

Keywords: China, Banking, WTO, Shanghai

I. SYNOPSIS OF BANKING IN CHINA

Local banks and financial institutions in China fall into five main categories: State banks, policy banks, share ownership commercial banks, urban co-operative banks and international trust and investment corporations. In a share-ownership bank various levels of government, Chinese institutions, and in rare cases individuals, hold shares. (Chen, 1999).

The People’s Bank of China (PBOC) has served as China’s central bank and the banking regulator since 1984. Three major, specialized banks existed under PBOC: the Agricultural Bank of China (ABC), serving the agricultural sector; the China Construction Bank (CCB), specializing in infrastructure finance; and the Bank of China (BOC), which acted as China’s foreign exchange bank.

In 1994, China formed three policy banks, the State Development Bank, the Import Export Bank and the Agricultural Development Bank. These banks took over the policy lending functions from the state banks so that they could focus on commercial business. Policy lending means that these banks are used by the Chinese government to fund policy projects, and as instruments for macro-economic control.

The bank restructuring process also led to the development of “share ownership commercial banks. Another new type of financial institution that was established during the commercialization process was the urban cooperative bank, which evolved out of 5,000-plus of China’s urban credit cooperatives through financial restructuring.

* Corresponding Author, University Drive, P. O. Box 1510, Pembroke, NC 28372. ramin.Maysami@uncp.edu, 910-522-5705.
Earlier in 1979, China had also created the international trust and investment corporations (ITICs), the total number of which has grown rapidly to 240 in recent years. Their major function is to raise foreign capital for local governments, with business ranging from direct investments to loans and financial derivatives.

The local Chinese banking sector is divided into four large banks, commonly referred to as the “Big 4” and many smaller banks. The Big 4 are wholly state-owned and subject to policy lending (Asiamoney, 2000) and account for 90% of all assets and 70% of all lending in the system. There is a high incidence of non-performing loans (NPLs), which was estimated at up to 50% of all loans and thus sums up to five trillion RMB (The Economist, 2002).

II. THE IMPACT OF WTO ENTRY

China’s accession into the WTO brings abundant opportunities to achieve greater market share, introduce a wider range of products and services, increase equity participation and streamline corporate structures, and gain control over distribution and after-sales services. China's Gross Domestic Product (GDP) is expected to double by 2010, with average annual GDP growth expected at about 7.2%. The World Bank estimates that China's share of world trade will triple in the next 20 years, bringing it close to 10%. China’s entry to the WTO changes the whole banking landscape of the country.

Today, over 200 foreign banks in China have only about 2% of the total banking assets in the country and a tiny fraction of the Renminbi (RMB) lending. As a result of the WTO market opening, foreign banks are expected to reap huge benefits, first in corporate banking and trade finance and in the hard currency retail market, and later in general retail banking starting in the coastal cities. Between 10% to 20% of all Renminbi deposits are expected to flow from local banks to foreign banks. Foreign banks not only have an overwhelming advantage in international investment banking but also have access to ample low-cost foreign currencies.

The Chinese Central Bank welcomes overseas institutions in the market, but there is concern that competition might be too stiff for domestic banks pampered by years of virtual government guarantees. Increased foreign competition will force Chinese State banks to quicken their pace of reform and commercialization. WTO accession offers this orderly platform for the much-needed reform to be introduced to the tightly regulated domestic banking scene. As a result, there will be a gradual transfer of best practices and management skills from abroad to the banks in China.

III. CURRENT BANK REGULATORY FRAMEWORK

After the founding of the PRC in October 1949, the PBOC assumed all of the existing Chinese and foreign banks’ functions. PBOC served as a central bank and government treasury. It directed and supervised all specialized subsidiary banks, non-bank financial institutions, and insurance companies.

Banks have been key targets for reform in post-1979 China. Among the government's more aggressive reforms have been the modernization of state-owned banks and the creation of new ownership structures. The government aims to move China's banks toward world standards of commercial organization, service, and competitiveness by strengthening the supervisory and regulatory environment and implementing sound banking practices. Strategies adopted include improving central bank independence, reducing the burden of past non-performing loans, adopting a new loan classification system to help bring China's loans up to international standards and relaxing control over interest rates to encourage lending to small and medium-sized companies. Further opening of China's banking sector to foreign banks, in response to WTO accession requirements, indicates government efforts to open up the financial services industry, thereby exposing Chinese banks to foreign practices and competition.
To facilitate the growth of foreign trade and direct investment, China initially allowed foreign banks to set up representative offices to engage in liaison service. Since 1985 however, foreign banks have been permitted to engage in foreign currency business as branches in special economic zones and selected cities. The opening of China’s financial markets, which adheres to the principle of gradualism and prudent management, has progressively expanded to open coastal cities and inland cities. The current regulations allow FFIs to establish not only representative offices and branches, but also joint venture banks and finance companies, wholly foreign-funded bank subsidiaries, and joint venture investment banks.

The regulatory framework experienced a major change with China’s WTO entry, and new regulations were issued shortly before the WTO. Changes in the regulations are still ongoing, and the information management poses a difficulty to the foreign banks since the laws first have to be translated internally within the organization from Chinese to English and distributed to the affected business divisions. A bank that intends to do business in China has to start by establishing a representative office (Tan, 2003; Isinolaw, 2003).

A representative office is only allowed to engage in non-operating activities such as consulting, liaison and market research (The People’s Bank of China, 2002). In order to establish a representative office, the FFI has to submit a formal application at the local branch of the PBOC together with the required documents, i.e. banking license, annual reports and the business plan (The People’s Bank of China, 2002).

After having operated a representative office for at least two years, the FFI can apply for a branch with foreign currency license. Branch offices are allowed to conduct profit-oriented banking business with certain restrictions. Depending on whether the FFI intends to set up a branch of a foreign bank or a joint venture (JV) finance company or a joint venture bank, different minimum capital requirements apply. For branches, the FFI has to possess net assets of at least US$20 billion at the end of the year prior to filing the application. Whereas for JV companies or JV banks, as well as subsidiaries of foreign banks or Chinese-Foreign joint banks in China, the minimum net asset requirement is US$10 billion, (Isinolaw, 2003; Trade and Industry Department and Trade Development Council, 2003).

The application for a banking license must be accompanied by a feasibility study that proves comprehensive research on the Chinese market (The People’s Bank of China, 2003). With a banking license, foreign banks can engage in foreign currency business all over China and with both Chinese and foreign customers (Câmara de Comércio e Indústria Luso-Chinesa–Delegação de Macau, 2003). Foreign currency deposits received in China by an FFI may not exceed 70% of its total domestic foreign currency assets (China Law & Practice, 2002). Business transactions in RMB still require a special licence issued by the PBOC and can only be granted to banks that have maintained operations in China for at least three years and that have been profitable for at least two consecutive years (The People’s Bank of China, 2003).

Further, RMB operations are restricted in terms of the geographical area and the type of customer and will be liberalized during the transition period 2002-2006. Limitations on market access also include restrictions on provision and transfer of financial information, financial data processing and related software by suppliers of other financial services. Advisory, intermediation and other auxiliary services, such as advice on acquisitions and corporate restructuring, investment and portfolio advice and so on, remain restricted for all specified activities. For financial leasing services, however, foreign financial leasing corporations will be permitted to provide financial leasing services at the same time as domestic corporations.

The China Securities Regulatory Commission (CSRC) recently issued a joint statement with the PBOC, promulgating the rules for the Qualified Foreign Institutional Investors (QFII) scheme which is to take effect from 1 December 2002 (Ng, 2002). Accordingly, QFIIs will be allowed to invest in RMB.
denominated Equity A-shares, Treasury Bonds, Corporate Bonds and Convertible Bonds listed on the stock exchanges. Currently, the regulators are in the process of laying out the detailed implementation procedures, such as account opening and application procedures, documentation requirements, settlement and clearing arrangements and so on. Therefore there is no definitive timeframe for the implementation of the scheme. Foreign banks like Citibank, HSBC, Standard Chartered and local giants Bank of China, Industrial and Commercial Bank of China and Bank of Communications, have all signed up for custodian bank licenses (Jorolan, 2002). Under the existing rules, FFIs can only apply for a QFII license through a designated custodian bank.

The purpose of China’s intermittent opening for foreign banks and the slow change of regulations are to prevent too rapid a success of foreign banks’ operations and to give local banks more time to enhance their efficiency (Asiamoney, 2000). With China’s WTO entry, foreign banks also face a termination of tax exemptions that they were previously enjoying in their very limited scope of operations (International Tax Review, 2001).

**IV. FOREIGN BANK OPERATIONS IN CHINA**

**Market Entry Strategies and Customers**

Given the restrictions on foreign banks during the transition period, a common market entry strategy for them is to buy a minority stake in a Chinese bank. Through the Chinese bank, the FFI would have access to those businesses that are restricted, or that are not in line with the overall strategy of the FFI. Such a move can also allow them access to the local currency through the savings accounts of their local allies and thus evade the more expensive interbank market. Additionally, local partnerships and alliances have resulted for the sole purpose of co-operation for mutual benefit. For instance, Deutsche Bank entered into an agreement with Bank of Communications for an e-trading deal allowing the former to use the local bank’s systems to access the accounts of the customers of the latter.

A variety of possible market strategies exist for FFIs entering into China. Some banks like Deutsche Bank do not engage in retail banking and focus on business customers instead. Certainly, multinational companies (MNCs) are a targeted and well-received clientele, especially if the FFI has already conducted business with certain MNCs in other countries. Other banks like HSBC offer both personal banking services including RMB operations and corporate banking services through several branches in China. FFIs like American Express target the underdeveloped credit card business in China and seek alliances with local banks to promote their credit cards.

MNCs are ideal customers for FFIs as they not only require RMB business, but also foreign exchange transactions and in most cases, already have established relations with international banks. However, FFIs are increasingly yielding to Chinese enterprises and individuals, too, in order to achieve reasonable growth rates for themselves. Their restrictions on RMB business can be overcome by alliances with Chinese banks. Chinese enterprises and individuals have thus far not experienced sophisticated asset management or credit management models since the existing models of the local banks are quite simple and not very developed. In this field therefore, foreign banks can benefit from their abundant international experience and from their sophisticated product portfolio.

**Risks**

Foreign banks operating in China face a series of risks that may threaten their sustainability in the long term. The Chinese government has the right to impose changes in the banking regulations which may
favour local banks during the transition period, e.g. by imposing geographical restrictions and additional capital requirements to foreign banks’ operations. Foreign banks have to be prepared for sudden changes and maintain flexibility until the banking sector completely opens up in 2007. Only banks with sufficient stamina will be able to survive in this environment.

Another threat is the outflow of operations know-how and technological skills, depending on the chosen mode of operation (e.g. JV or collaboration). FFIs may have to modernize operations of the allied local banks and be forced to provide their local partners with advanced marketing and IT skills without the security that this knowledge would be kept confidential.

FFIs holding a minority stake in Chinese banks must verify if there are overlapping customer segments which would lead to competition rather than collaboration with their ally. Consequently, most foreign banks limit their collaboration with local banks to an absolute minimum or prefer to operate alone.

During the transition phase, FFIs will not have access to Chinese savings accounts and have to use the more expensive interbank market to borrow Chinese currency from local banks. This disadvantage in the cost structure of RMB supply is a serious problem because many local enterprises and increasingly, MNCs as well, request credits in RMB.

Opportunities

China, on the other hand, offers a number of opportunities for FFIs. The biggest opportunity is probably the fact that a vast amount of financial products just do not exist in the present Chinese market. Such products include consumer credits, credit cards, asset management and pension funds, investment funds and so on, that are both successful and profitable in other countries. Since all these products are non-existent in China, there is undoubtedly an untapped potential for huge profits. Foreign banks have abundant expertise in these areas and can use them as leverage in the Chinese market. Most FFIs also have a low rate of NPLs and do not have to engage in the risky loan business with state-owned enterprises (SOEs).

As a result of China’s WTO membership, imports and exports will grow at high rates and consequently, many enterprises will require banks that are adept in international transactions. Again, this is the playground of foreign banks while Chinese banks do not yet provide serious competition.

Foreign banks usually have streamlined and efficient operations and have enhanced their productivity and decreased their operational costs significantly over the years. This signifies a strong competitive advantage over the Chinese banks. FFIs also have a sound management system and efficient and transparent decision-making mechanisms (Mi et al., 2002).

V. FOREIGN BANK EXPERIENCES IN CHINA: THREE CASE STUDIES

The presence of FFIs in China is rapidly growing. Recent reports state that 214 representative offices and 190 business institutions are currently present in China, with combined assets of US$45.2 billion (Xinhua, 2002). According to the press release, 31 foreign banks have been issued licences to deal in RMB.

Forecasts of the market share that foreign banks can achieve in China vary greatly, depending on the source and the motivation of the source. Reliable estimations are currently not available. The following sections of this paper discuss the activities, strategies and challenges of some of these financial institutions operating in Shanghai, the financial center of China.
Deutsche Bank AG Asia Pacific and Shanghai Branch

Deutsche Bank AG (DB) was founded in 1870 and ranks among the Top 20 of all Financial Institutions worldwide with a total market capitalisation of €48.8 billion (Financial Times, 2003) and total assets of €918 billion (Deutsche Bank AG, 2003). The bank offers a variety of financial products and services to private and corporate clients, including the full range of investment banking services. Further, DB is one of the leading providers of banking services, such as custody, cash management, asset management and private banking. The successful integration of the U.S. investment bank Bankers Trust in 1999 has strengthened DB’s position in this business worldwide, enabling it to secure a strategic position among the top echelon of U.S. financial institutions. DB is capable of offering clients comprehensive services in the Americas, Europe and Asia Pacific. Today, 95,000 staff in 2,300 offices service close to 18 million clients in 70 countries around the globe. The bank is organised in three groups – Corporate and Investment Banking (CIB), Private Clients and Asset Management (PCAM), and Corporate Investments (CI).

The Asia Pacific region has always been an integral part of DB’s strategy (Deutsche Bank AG, 2000). As per total assets under management, the bank ranks among the top 30 institutions operating in the Asia Pacific region (The Asian Banker, 2002b). DB currently employs over 6,000 staff in 13 Asian countries. In 1988, the bank established its head office for the Asia Pacific region in Singapore. Since then, the bank has been operating under a wholesale banking licence. There are two legal entities, which, under the Banking Act (The Monetary Authority of Singapore, 2001), offer the entire range of financial services (except for retail services) to local corporate and private clients in Singapore – Deutsche Bank Asset Management (Asia) Limited and the Deutsche Bank Singapore Branch (CIB and PCAM).

Deutsche Bank employs approximately 100 staff in Mainland China. In Shanghai, DB has been holding the status of a representative office since 1995 and converted into a branch in 1999. Since then, a number of licences have been acquired to conduct business in China through the bank’s three offices in Shanghai, Beijing and Guangzhou. Beijing, currently operating as the sole representative office, is being considered for conversion into a branch in the medium term. The RMB licence has recently, in 2002, been issued to DB. Geographically, the Shanghai branch covers central China and parts of the East and West. The Beijing representative office covers the Northern provinces and cities, while the Guangzhou branch covers south China. The branches, like other branches in the Asia Pacific region, are organised in accordance with the world-wide group structure (Hamer, 2002).

Like other foreign financial institutions in China, the major competitive advantage is the wider range of products and the high quality of customer service offered. At DB, the single point of contact for a customer is the so-called Lead Relationship Manager (Lead RM), who is responsible for the customer throughout Mainland China. DB, in China, is mainly active with corporate customers that the bank services worldwide. The clear focus is on multinational corporations from the U.S., Europe (ex Germany) and Germany. Having been granted a license, Deutsche Bank would be able to maintain operating accounts with large local enterprises (LLC) in the short term. However, existing cross provincial regulations make it difficult for foreign banks to maintain operating accounts with local corporations.

The current restrictive regulatory environment and frequent changes present a hindrance in doing business. While most of DB’s business in China is conducted with foreign corporate customers, cash management offers e-banking services to Chinese clients as well. The key focus on conducting business with local corporate customers in China lies on offshore banking activities, for example IPO’s, M&A, debt issuance, cash management and trade services in other countries in the event the LLC expands operations internationally. However, since investment banking business is not permitted through the Shanghai Branch, the same is conducted through the investment banking office in Hong Kong.
Compared to other foreign financial institutions, DB has entered the Chinese market relatively late. Consequently, there exists potential for developing new areas, such as domestic currency market and exploring profitable business opportunities. The bank is of the view that business will grow with the opening of the financial markets and Shanghai will further develop to become an important financial centre. Therefore, many of the bank’s business and service divisions have been concentrated in Shanghai. In view of the local currency business, coupled with the gradual opening of the derivatives market (forward contracts, options, and swaps), Deutsche Bank can be expected to grow significantly.

The Development Bank of Singapore Ltd. Shanghai Branch

The Development Bank of Singapore Ltd. (DBS) is the largest bank in Singapore as measured by total assets, which accounted for S$151 billion in 2001 (DBS, 2003). In its home country, DBS holds the dominant position in consumer banking, treasury markets, securities brokerage, Singapore dollar loans, deposits and equity and debt fund raising. The current regulatory environment and restrictions for foreign banks operating in Singapore protect DBS from losing significant market share in the domestic market. Internationally, DBS has acquired the Hong Kong based Dao Heng Bank and DBS Dwong On banks operations, making it the fourth largest banking group in Hong Kong. Beyond its anchor markets of Singapore and Hong Kong, DBS is serving corporate, institutional and retail clients in Thailand, the Philippines and Indonesia.

In China, DBS is operating from two offices in Shanghai and Beijing. The bank entered the market in 1995 and is currently focusing on bond issuance, IPOs, US$-denominated lending, and restricted RMB business with foreign companies, i.e. Singaporean and foreign invested enterprises. There is no intention to enter the retail market in the short term. The bank foresees Shanghai as the future financial centre for China. Hong Kong would retain its role for the South China market and Singapore would serve clients in South East Asia. Though business opportunities in Shanghai are growing as a result of the WTO liberalisation plans, the current regulatory environment and capital requirements hinder the bank from total market entry. Hence, Singapore and Hong Kong remain DBS’s major business operations.

The advantage of DBS over its local competitors lies in the ability to offer supreme products and customer service to its clients. DBS also relies on its strong customer base from Singapore, which is entering the Chinese manufacturing and high-tech market. For DBS, cultural issues play a less important role in comparison with other foreign banks, as most of the expatriate staff is of Singaporean-Chinese background and hiring local staff is not considered an obstacle.

As state owned banks are able to offer cheaper loans to the local enterprises, it remains difficult to build up a local customer base. The bond and IPO market is still very restricted and access can be obtained through joint venture agreements only. However, like other foreign banks, DBS considers partnerships only in very exceptional cases.

The current regulatory requirements prevent foreign banks from total access to the financial services sector. The strict foreign exchange and capital controls further obstruct business in China. Business is being set up to the extent possible and the bank has to rely on its long-term earnings and business prospects. In other words, short term profits are not expected from the foreign bank’s China operation. However, profits may be leveraged from the opening of capital markets through Qualified Foreign Institutional Investors agreements (QFII), which enable foreign companies in China to invest in specified instruments listed on the stock exchanges. The legal system, compared to other financial centres, is not yet comprehensive and developed to an extent that would ensure fair and transparent judgement in all business related juridical cases.
Dresdner Bank Group Shanghai Branch

Dresdner Bank Group (Dresdner) is one of the leading banking groups in Europe with total assets of €507 billion (Dresdner Bank AG, 2003). The bank’s 1,120 branch offices and more than 50,000 employees are active in over 70 countries around the world. Since July 2001, Dresdner has been part of the Allianz Group as the centre of competence for banking. The combination of Allianz and Dresdner creates value addition to those customers who demand a wider range of financial and insurance products through broader sales channels and with greater advisory capacity and expertise.

In China, Dresdner has been present since 1980 and registered its first branch in 1990. The bank respects the Chinese culture and recognizes the necessity to build customer relationships at an early stage. Consequently, Dresdner is already experiencing the advantage of ‘being among the first movers’. As the first among the around ten German banks with a presence in China (mostly representative offices), Dresdner has successfully applied for its RMB license and local business license (local customers). The bank is focusing on those business opportunities that are not currently offered by local banks such as trade finance and structured loans. Shanghai’s increasingly modern infrastructure improves the accessibility of the local market. However, restrictions and limitations prevent the bank from reporting short term profits. Today, Dresdner’s client base is predominantly located in Shanghai and consists of small and medium sized German and foreign enterprises.

Dresdner Bank leverages its competitive advantage from its strong ties with German SME’s and Allianz Group’s brand name. The management plans to gain access to the domestic retail market, SME market, wealth management and insurance market more intensively in the long run. Like other foreign financial institutions in China, Dresdner Bank views its ability to offer specialised and niche products, such as structured deposit products and e-banking, and supreme services as the most important competitive advantage in the long run.

The domestic legal system, risk management practices and cultural differences pose obstacles in conducting business. In addition, concerns regarding human resources, possible know-how transfer and the ability to maintain sufficient capital base in a constantly changing regulatory environment are some of the risks experienced while doing business in China.

The current regulatory environment does not encourage or attract foreign banks to a satisfactory extent to form alliances with local partners. Hence, profitable business areas currently remain inaccessible for Dresdner Bank. However, as the regulatory and legal system matures and customer relationships are established, the bank hopes to achieve profitability and business growth in the coming years.

VI. SUMMARY AND RECOMMENDATIONS

Notable amongst the findings, is the lack of satisfactory regulations and laws in Shanghai vis-à-vis the advanced and developed, albeit restricted, financial services environment in, say Singapore. Greater effort needs to be made by the Chinese government and the central bank (PBOC) to further enhance business opportunities, market attractiveness and profit potential for both local and foreign financial institutions.

Nevertheless, despite the domestic shortcomings in China, most FFIs that have set up operations in the country, especially in Shanghai, seem to be confident of expanding their customer base significantly in the years ahead. Shanghai’s status as a major business centre in the People’s Republic of China makes it increasingly likely that the city will emerge as an important domestic financial centre in the medium or long term.
Moreover, many institutions view the availability of qualified and motivated local staff as satisfactory and sufficient.

Conversely, a major weakness of foreign banks’ operations in Shanghai is the current negative impact on the consolidated firm’s balance sheet. Under the restricted regulatory framework, it is unlikely that significant profits will be generated in the short run. In addition, in the absence of necessary licenses and approvals, especially in case of late entrants, business opportunities are significantly curtailed. Early entrants, too, struggle to build a customer base in the local market. Therefore, in such a scenario, FFIs’ primary focus is on foreign companies. The limited access to local currency deposits results in foreign banks acquiring the Renminbi currency via the interbank market. Consequently, interbank lending practices result in a further reduction of the bottom line.

Continuous and often-unforeseeable changes in the regulatory and legal framework pose a major threat to new entrants to the Chinese financial sector. The domestic regulator, namely PBOC, provides little transparency, resulting in inefficient business operations on account of insufficient information supply. The immaturity of the legal framework, too, is often criticised. However, China is aiming to reduce and eventually eliminate these obstacles in a speedy and transparent matter.

In drawing final conclusion, we focus on the opportunities for foreign banks in China. First, it is a stated fact that China’s entry into the WTO opens vast business opportunities for foreign companies and financial institutions alike. On-site experience of foreign banks in Shanghai has proved that early entry into the Chinese market provides an opportunity to establish the necessary networks with governmental and regulatory institutions, as well as profound and stable customer relationships with most foreign corporate clients. Lastly, in view of the present underdeveloped domestic financial market, described earlier, tremendous business potential exists, especially if foreign banks focus on their key strengths and product lines, and expand into markets that local institutions cannot currently satisfy.

REFERENCES

A complete list of references is available from the corresponding author, Ramin Maysami. Please e-mail your request to ramin.Maysami@uncp.edu.
**SWOT Analysis of Foreign Banks’ Business**

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**Figure 1**
SWOT Analysis of Foreign Banks’ Business Operations in Shanghai