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Robert T. Martin, Managing Director and Regional Executive, Bank of Montreal, BMO Financial Group – Doing Business in China

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Abstract

This interview concerns doing business in China given the rapid changes and industrial development of that country. This report is based on an interview with Robert T. Martin, Managing Director & Regional Executive of BMO Bank of Montreal in June, 2005. Recent federal government financial reform efforts in China have facilitated foreign banks' business development as part of the Chinese WTO market-opening commitment. Foreign banks' development in the Chinese market is based on client demands and product expertise. The banks are concerned about increasing competition, the ability to be sustainable long-term, and innovation through new products introduction in niche markets that are regulatory compliant. For new investors in China, potential opportunities continually occur, but reasonable expectations can only be made with regular visits to China and continuous intelligence gathering to keep abreast of the evolving dynamics.

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Introduction

China as a market exhibits enormous potential based on its vast population and rapid economic growth, especially after its entry into the World Trade Organization (WTO) in November 2001. The 2005 global retailing report by IGD (a leading education and research organization in the food industry) predicts that China's contribution to global food retailing will nearly double from 8% to 15% between 2003 and 2020. This would make China the world's second largest food retail market behind the US. Such factors encourage continuous enthusiasm for international trade and foreign investment in China. In 2003, global foreign direct investment (FDI) influx to China was sufficient to rank it first globally, exceeding the US for the first time (JETO White Paper on International Trade and Investment, 2003). At the same time however, a recent survey from China Economic Quarterly (CEQ) disclosed that foreign businesses are struggling to be profitable in China given low margins and intense local competition (cited by foodproductiondaily.com, 2004). The opening of China's financial markets began with banking system right after its entry into WTO. Under the WTO agreement, China has promised to completely open its banking market in 2007. Hence, foreign banks' business development in China reflects China's evolving investment environment and the continuing financial reforms.

Robert T. Martin, Managing Director & Regional Executive of Bank of Montreal (a member of BMO Financial Group) discussed the critical factors BMO faces in developing a market presence in China. He also provided suggestions to foreign investors that have interests in conducting business in China.

As an MBA graduate from the Wharton Business School of the University of Pennsylvania, Martin joined in BMO Financial Group in 1980. Partly because of his long-standing interest in China and Asian studies, his expertise has been focused on Asia for the past few decades. In 1996, Martin moved back to Hong Kong to continue his regional executive assignment in Asia. Prior to this he had over ten years' work experience in Japan, Korea and Hong Kong with BMO. In Asia, BMO has offices only in China including Taiwan but they also conduct extensive business relationships in other Asian countries, such as Japan and Singapore. BMO's business activities in China present a small but increasing percentage of BMO's financial performance, and are regarded as important for their overall relationships with clients within and outside China.

Major Financial Services in China

"Our ability to assist our clients in China makes us a more valuable business partner."

Founded in 1817 as Bank of Montreal in Canada, BMO Financial Group aims to be a top performer in the financial market of North America. It provides a broad range of personal, business, corporate, and institutional services through its three major divisions in retail banking, wealth management and investment banking. In its home market across Canada and the US, the BMO retail banking section is the largest among its three divisions in number of branches and employees. However, in China, the primary focus is corporate investment banking with emphasis on building institutional relationships. Martin explains that one concern for this is that individual recognition in retail services is insufficient in foreign markets as China. This is also partly because the current stage of liberalization of the financial services market in China is limited by the business that foreign banks can do with domestic individuals. BMO's current business in China includes trade finance, capital markets in foreign exchange business, correspondent banking (with local banks), and corporate lending. BMO is the leading foreign bank in terms of foreign exchange volumes in China.

Under the current trend of increasing immigration from China to Canada, Bank of Montreal also assists new immigrants by providing them financial information and building up their first banking relations with Canadian banks. Moreover, BMO has started direct investment through its investment bank in a Chinese fund management company named "Fuguo" in Shanghai since 2002. This makes Fuguo company the only one with foreign shareholder among the first ten fund management companies licensed by CSRS (China Securities Regulatory Commission) in late 1990s. Beside BMO, the other five major owners are all domestic securities companies. BMO provides not only foreign capital investment, but also technical support to enhance Fuguo's fund management procedure, new product design and marketing, product assessment, and staff training and evaluation. This investment makes BMO a frontrunner in its field in terms of direct shareholdings in a Chinese fund management company. Martin indicates that this investment broadens the BMO group's business scope to retail services in China in the form of domestic mutual funds sales and creates strong local partners for locally based services.

Branches and Representative Offices in China

"If you have both clients and product expertise with competitive advantage, that's a very good combination."

The BMO group has three branches in Hong Kong, Beijing and Guangzhou and two representative offices in Taipei and Shanghai. Martin points out that outside BMO's home markets in North America, China is currently the country with the largest number of offices. The key factors for choosing these cities and the level of business activities are client demand, product expertise and BMO's own sustainable competitive advantages.

For example, after establishing two branches of Hong Kong and Beijing and one representative office in Taiwan in early 1990s, BMO was looking for another Chinese city in which to open a new representative office. Although BMO first considered Shanghai, there was already another Canadian bank and the Chinese regulators encouraged BMO to consider Guangzhou. The Guangzhou representative office has proved to be very productive and was upgraded to branch office level just one year later in 1995. Martin mentions that the financial market of Guangzhou does not have the same intense foreign bank competition as that of Shanghai. More importantly, Guangdong Province, with Guangzhou as its provincial capital, has long been the No.1 export/import province in China. Martin also points out that rapid development in China has changed the outlook since the early 1990s and the Chinese government regulators have also adjusted their approach accordingly. They now try to take an objective position in a more open market manner. If the same choice were to occur today, BMO would have initiated business in both cities. Although the representative office in Shanghai was not opened until 2001, it has the potential to be upgraded into branch office in the future.

Foreign banks in China face certain restrictions in conducting RMB (Chinese currency) business and the number of branches they can operate in major cities. Since BMO focuses on wholesale and investment banking, there is less need for local branches and they are satisfied with the current office numbers in China at present. Martin also indicates that financial product concentrations vary among cities for historical reasons. For example, capital market business in foreign exchange is concentrated in Guangzhou; but a lot of trade finance business is in Beijing.

Clients' Principal Business Styles

BMO has a diversified foreign client base in China including sectors in manufacturing, services, and agribusiness. Typically, these companies may start off importing into China. As time goes by, they may consider the cost pressure in their own countries and may choose direct investment or strategic outsourcing in China. Martin mentions that in 2004, China became a net importer of agricultural goods, indicating many opportunities for foreign agribusiness exporters and retailers.

In the case of direct investment such as joint ventures or wholly owned ventures, BMO can help with corporate lending and foreign exchange products. Sometimes their clients also require consulting services in choosing local partners and meeting local regulatory requirements.

The branches of BMO in China also have domestic clients with needs for specific products such as foreign exchange products. Martin says they are much more careful in local lending because of the relatively higher risks and less information about clients in a foreign market as opposed to their home market. Martin also points out that there are some lower risk products they can provide. "Now more Chinese companies are investing abroad. We are very interested in assisting them."

China: A New and Liberalizing Market for Financial Services

"A gradual but not too fast change is more conducive for keeping the healthy environment for the economy of China."

Started as the oldest Canadian bank, BMO is primarily a North American super-regional bank with Canada and the US as its home markets. It also seeks niche opportunities of diversified financial services in different parts of the world. In Martin's view, China is a relatively new market with limits on the types of businesses they can enter. However, as China liberalizes its market and becomes one major engine of growth in the 21st century, it becomes more important for foreign investors. Although volatile, China is still a very promising market with an acceptable risk profile in Martin's view. As he puts it, "China is liberalizing in a reasonable way. I suspect that such changes will take place in a small and gradual way in order to ensure stability and healthy environment."

The Asian financial crisis in the late 1990s rang a warning bell of potential imperfections in the current international financial system, especially in the immature financial market of East Asia. The crisis also justifies China's cautious financial policy in macroeconomic control and surveillance of the market security. This is especially true regarding the short-term floating capital and foreign exchange control during the gradual liberalization of its financial market. In response to this point, Martin admits that although a large-size economy decreases vulnerability to financial crisis, regulators are always concerned that speculators become discouraged from entering the market and consequently causing sudden capital flight.

Martin also provides his comments on the current important issues of WTO and RMB revaluation. From the view of the financial services sector, BMO is very pleased with the progress in opening the banking market since China's entry into WTO in late 2001. They also see obvious improvement in their own capacity in conducting local currency finance and in dealing with a larger group of clients than before. In earlier years, overseas banks in China could only conduct foreign currency business with local customers. By the end of 2004, China has announced 18 cities that are open to overseas banks for conducting RMB business. As an example, Martin mentions that just a few days before this interview, BMO has received the permission for the first time to conduct RMB transactions in its Guangzhou branch. So far the clients are pleased with this progress. They are planning to get such permission for their Beijing branch in the future.
On the date of this interview, the hot debate over RMB strength and revaluation still focused on whether RMB should appreciate. Martin remarks that China has to

make decisions based on its own requirements rather than simply responding to the political pressures from other countries. At some point China may try to add more flexibility in foreign exchange. Martin further illustrates, "A stronger RMB will be positive for many Chinese importing companies, although on the exporting side it could be a bit negative. Still the differential in wages and costs between China and the [international] market price is so great that a relatively small adjustment in exchange rate won't make much difference to China." He believes that over time China is going to have a more flexible exchange regime. "It's just timing this with the development of the country and the strengthening of banks so that all could happen in a more stable manner."[1]

Relationships with Chinese Regulators and Local Banks: Strong Dialogue and Cooperation

Martin stresses the importance of maintaining good relationships with government regulators and on-going dialogues with various sectors and industry groups. Such conversations can be achieved through various kinds of meetings at many different levels.

The major regulatory institutions for foreign banks include China Banking Regulatory Commission (CBRC), People's Bank of China (PBOC) and State Administration of Foreign Exchange (SAFE). In mutual funds and securities business, there is the regulator of China Securities Regulatory Commission (CSRS). The functions of these regulating agencies used to overlap in some way but are in recent years, performed more distinctively. Martin recognizes the positive change over time in their outlook and efficiency. "As the market liberalization brings with it many more new issues, these bodies are highly professional and are willing to discuss a wider range of issues." Martin emphasizes that BMO's philosophy is to have open dialogues with regulators for mutual transparency and understanding. Martin also regards personal network among their Chinese employees as a valuable source of building local relationships.

Martin regards Chinese banks to have a natural home advantage and to know the local clients better than foreign investors. He also thinks that foreign banks' entrance can aid the Chinese market by introducing global technological, management and marketing perspective. More importantly, foreign banks enter in niche areas where they can raise the competitors' atmosphere and encourage Chinese banks to develop more rapidly. BMO works closely with Chinese banks. Martin adds, "Our relationship with Chinese banks is much more like cooperators

[1] Just one month after the interview-July 21st, 2005, China announced the change from fixed exchange rate regime to managed floating exchange rate regime, which is regarded as a milestone for China's currency reform. From that time until the present (April, 2006), Chinese currency, RMB, has gradually appreciated.

than competitors. We provide training programs in risk management and also have a lot to learn from their perspectives of local practices."

Pressure and Concerns

"There is a lot of pressure now on hiring good local staff." Martin explains that there are more foreign companies entering China who want to hire locally while domestic companies are also offering more competitive salaries than before to retain staff. So BMO faces high degree of competition in finding and maintaining good people in workforce.

"The current regulatory capital requirement for branches like ours is relatively higher than international standards." Martin comments that branches like theirs are probably overcapitalized and it is expensive to hold a lot of capital. Meanwhile, they are also concerned about increasing the capability of competition and sustainable development, and introducing their new products in a way that are both regulatory compliant and useful to the client. Chinese regulators have been aware of these concerns. Martin believes that over time the situation will evolve in a positive manner.

"I am very optimistic about the Chinese market." Martin illustrates this point by saying that Chinese culture emphasizes education and hard work hard as a means to build a more positive future. Of course business cycles go up and down, and there will always be some problems. But he believes that the overall direction is quite positive for the Chinese market. Is this overly optimistic? Martin thinks that it is not based on some unrealistic suspicion, but on real and attainable conditions as shown in China's efforts for market liberalization.

Suggestions to Foreign Investors New to the Chinese Market

"The cycle of new opportunities in China can change so quickly that it is still possible to enter the market even at a later stage."

For first-entry clients into China, Martin suggests that they make a number of visits, meet as many people as possible, and get to know the government and relevant regulations. Often when people first visit China, they may be too optimistic and too excited with the large market potential. When they go back several times and gain more experiences, their expectations become more realistic. "Expectations about China at the early stage are usually very high, but it's best not to make a lot of critical decisions on the first trip." Martin also emphasizes the importance of building personal relationships. "In some countries like China, personal relationships may be even more important than institutional ones."

What about the concern of first-mover advantage? Martin's opinion is, "Those having been in the market earlier may demonstrate better staying power and understand the market better, and hence may be more realistic in their expectations. That's the advantage of being first-movers." But he also points out the other side, "For the earlier stage movers, because there was not enough information and people did not have a lot of experiences, some may face more pitfalls and may not make much money early on. Hence, it is not necessarily correct to think that it is too late now because other companies are already there. Even if a company hasn't yet set up a large business relationship with China, I think it is never too late to start."

For direct investment, Martin suggests that most of the companies initially feel the pressure from the market that they need to take action. Among the options Martin recommends wholly owned ventures if the type of business can ensure the control of management, marketing, and technology. He also suggests this business structure when protecting technology and intellectual property is extremely important. But in some business sectors, local partners are vital to get permit and product distribution channels in which case joint ventures are a more viable structure and would establish the best rapport with local suppliers and customers. Another possibility is collaboration with a third country company that has closer relationships and a better understanding with the Chinese market.

Summary

Martin's comments reflect the efforts from China to meet its market-opening commitment after its entry into the WTO. Foreign banks' development in China's markets is based on two key drivers: client demands and product expertise. Foreign banks are concerned about the capability of competition and sustainable development, and new product introduction in niche market that are regulatory compliant.

China is a large and promising market with both big opportunities and challenges. In financial markets, it remains relatively restricted while facing gradual liberalization. Although some large foreign banks are trying to enter China's lucrative retail banking market, more foreign banks' competitive advantages are still in niche products and services for target markets. Foreign banks with their advantages in developed skills and international networks may also attract Chinese corporate clients who want to engage in international business.

First time investors in China are cautioned not to become overly optimistic. Since China is changing and developing quickly, first-mover advantage is not the only issue that matters. Reasonable expectations of the Chinese market can only be made with regular visits to China and continuous intelligence gathering to keep abreast of the evolving dynamics. Furthermore, they should try to establish good personal relationships as well as institutional ones. By all means, it is never too late to consider starting business in China.

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