London and the World: **Chinese financial institutions**

Overview

Chinese financial occupiers and the Central London office market

■ Chinese financial institutions are amongst the largest in the world, and over the last decade they have become increasingly integrated with the global economy.

■ Since the global financial crisis of 2008 Chinese investment into the west has risen, resulting in a great deal of business from which Chinese financial institutions can capitalise. This investment is forecast to continue increasing, and could reach in excess of US$1 trillion by 2020.

■ The continuing internationalisation of Chinese financial institutions, along with the increasing opportunities they have to capitalise on business in the west, will lead many to launch large requirements in the City of London - we estimate they could take in excess of 2 million sq ft in the City over the next decade.

■ This research paper examines Chinese financial institutions, their reasons for expanding into London, and the kind of space they are likely to take.

"If we want to reach out to the rest of the world and become further integrated with the global economy, London should be the first port of call."
Liqun Jin, Chairman of China Investment Corporation's board of supervisors, 2010

Who are China's financial institutions?

Four of the ten largest banks in the world are Chinese: the Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China and Bank of China. These banks are known as the "big four" and, together with the Bank of Communications, they control around half the total assets in China's banking industry, with the next biggest players - 12 joint-equity banks and three policy banks - controlling around 24% of total assets.

Insurers are also big players in China's financial system. Like banking, the insurance market is concentrated, with the largest three firms – namely Ping An, China Life Insurance and the People's Insurance Company of China - holding more than 70% of the market in both life and property insurance.

Chinese insurance companies hold US$1.2 trillion in assets, making the industry smaller than those in countries with more developed financial systems. But, despite being under-developed, the expansion of the Chinese economy and the rapidly growing amount of insurable exposures mean China's insurance industry is expanding quickly.

After banks and insurance firms, trust companies are the biggest financial sector. In China, trust companies are asset managers for high net worth individuals and companies as well as being a source of credit for firms in need of funding. As such, they promote innovation in a financial system long-dominated by state-owned institutions. Unlike banking and insurance, this sector is not dominated by a small number of large firms (the ten largest account for just 44% of the total net profits in the industry). But in common with banking and insurance, the potential for growth is huge - the amount of assets under management grew from RMB 380 billion in 2006 to a reported RMB 7.5 trillion in 2013, and the sector could soon overtake the insurance industry in size.

> "China's financial sector grew from 472% of GDP in 2008 to 612% in 2011, and this number is expected to reach almost 800% in 2016."

Another growing industry is that of asset management. Like the insurance and trust industry, this is an underdeveloped part of China's financial system (it was reported in January 2013 that assets under management in China are equivalent to just 5.1% of GDP, this is compared to 240% in the US). However, the number of funds has been increasing markedly since the emergence of the industry in the late-1990s, and is forecast to continue growing.

As a whole, China's financial sector grew from 472% of GDP in 2008 to 612% in 2011, and this number is expected to reach almost 800% in 2016. If landlords and developers are to benefit from their expansion into western financial centres, it is important to have an understanding of factors shaping the locational preferences of financial sector occupiers at home.

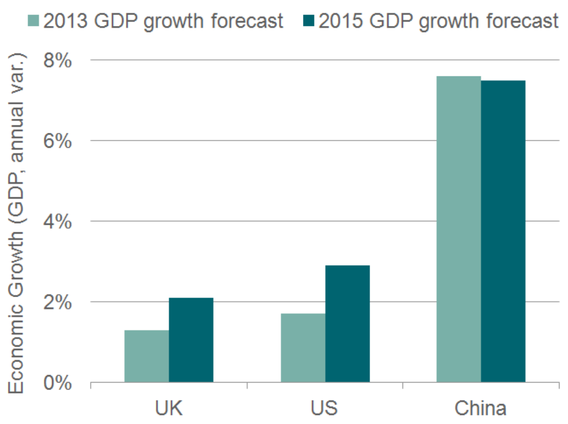
Shanghai and Beijing

On the mainland, Shanghai makes the most convincing global financial centre. The city ranks at number 16 on the Global Financial Centres Index, it has the highest concentration of foreign banks on the Mainland and a range of equities and commodities markets, which include the largest stock exchange in China, commodities exchanges in gold and metals, a futures exchange and the China Foreign Exchange Centre. So perhaps it is surprising that most of China's financial institutions prefer to have their headquarters in Beijing.

Beijing's most significant advantage lies in its role as the capital of China and home to the institutions responsible for managing and determining the economic and political life of the country: the National People's Congress, the State Council and the Central Bank, as well as all other agencies that regulate the financial industry are based here.

GRAPH 1

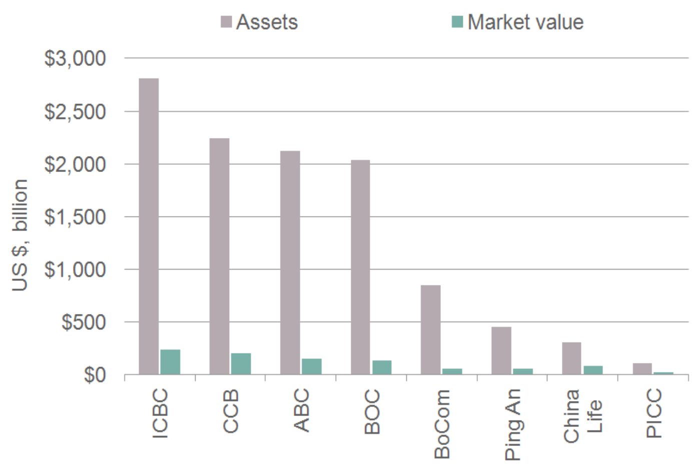
China's continuing growth



Graph source: Focus Economics

GRAPH 2

China's financial institutions



Graph source: Forbes

The government not only regulates these institutions, it is an intrinsic part of them. The five largest Chinese banks are majority owned by the state, and there are significant government stakes in many other financial institutions, meaning executives at state-owned financial institutions are also likely to be high-level government officials. Beijing therefore exerts great influence.

Shanghai's status as a global financial hub is down to its financial centre, Pudong, being designated as a special economic zone by the Chinese government two decades ago. As such Pudong has been granted liberties - largely concerning foreign business – which have been restricted in other parts of China. Most significantly, foreign banks have been able to operate from there since the early 1990s.

The differences between Shanghai and Beijing which have become apparent since then are best explained by the dual HQ strategy of China's financial institutions. People's Bank of China is a good example. PBOC has headquarters in both Shanghai, and Beijing, and while the Beijing office runs policy-oriented operations relating to monetary policy, financial research, note issuance, statistical data and anti-money laundering, the Shanghai office focuses on market-oriented and international activities. Indeed, any organisation making commercial-based decisions related to the global economy is more likely to operate from Shanghai than Beijing.

What can we ascertain from Chinese financial institutions' locational preferences at home? The most pertinent fact is this: although these institutions are intrinsically linked to the state, their choice of location can be based on the emphasis given to commercial lines of business.

If London's landlords and developers wish to ascertain the likelihood of increasingly commercial-led decisions bringing Chinese banks, insurers, asset managers and trusts to financial centres in the west, they should look to Hong Kong.

Hong Kong

With no controls on capital inflows and outflows and access to virtually all complex financial products available in the west, Hong Kong's market is as free as that under any jurisdiction in the world.

Chinese financial institutions entered Hong Kong upon the transformation of the state-owned banks into joint-stock commercial banks and the listing of those banks on the Hong Kong Stock Exchange. Bank of China, China Construction Bank and Industrial and Commercial Bank of China were the first to list between 2005 and 2006 and, by doing so, they were able to access foreign equity capital, add to their capital base and form strategic alliances with some of the world's biggest banks.

Chinese financial institutions have evolved through these strategic alliances; Industrial and Commercial Bank of China's alliance with Goldman Sachs, for example, meant the US investment bank was able to provide expertise on lines of business including asset management, corporate and investment banking.

Furthermore, while in Hong Kong, Chinese financial institutions have been required to operate by international standards, with shareholders and investors able to push for corporate governance improvement, greater transparency and higher operating efficiency.

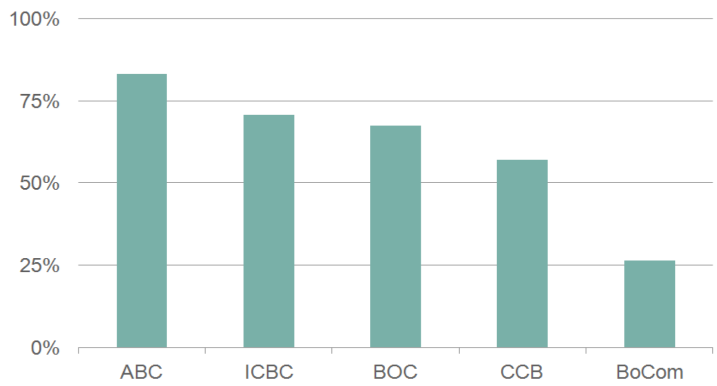
As a result of this process, Chinese financial institutions have grown (in 1996 total assets of Mainland banks in Hong Kong amounted to HK$870 billion, and in 2009, this figure had risen to HK$2 trillion) and have become increasingly international. The growth of these institutions in Hong Kong, and the resultant escalation in international and commercial-led decisions has not only benefitted the state-owned behemoths, it has benefitted Hong Kong's landlords and developers, with Chinese financial institutions currently occupying around 4 million sq ft of office space in Hong Kong.

Occupational preferences in China

Historically, property has been one of the best investment options open to Chinese financial institutions. Equity markets in China are volatile, bond markets are thin, and the secondary bond market is in its nascent stages. However, Mainland entities of Chinese banks are currently unable to acquire

GRAPH 3

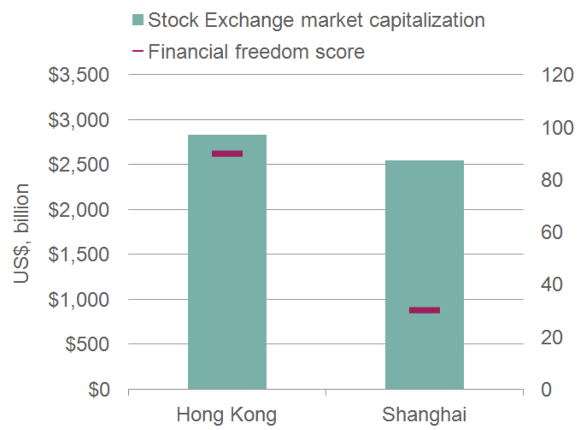
State ownership of China's equitised commercial banks



Graph source: Congressional Research Service

GRAPH 4

Economic freedom



Graph source: World Federation of Exchanges, 2013 Index of Economic Freedom

Moving outward

Case study: ICBC's path to Hong Kong

■ Prior to 2005, Industrial and Commercial Bank of China was fully financed by the state through the Ministry of Finance. To improve corporate governance in the finance sector the state had to relinquish part of the ownership to non-state investors in exchange for more efficient monitoring.

■ In 2005, ICBC was restructured to a joint-stock limited company, with the Ministry of Finance and Huijin each holding 50%. In 2006, ICBC brought in Goldman Sachs, Allianz and American Express as strategic investors, and in 2007, ICBC further diversified its ownership through simultaneous IPOs in Shanghai and Hong Kong. As a result, state ownership was diversified and corporate governance improved.

■ By introducing new investors ICBC strengthened its objective of maximising and changing its service culture. By listing on the Hong Kong stock Exchange and Shanghai Stock Exchange separately, the bank was required to operate by international standards, which brought in international auditors and added compliance rules.

■ The public monitoring and outside control by international investors reduced risk, improved Capital Adequacy Ratio, brand value and market value and disclosure. With more disclosure and transparency, ICBC opened the door for international expansion and cooperation.

"Chinese financial institutions are willing to pay a premium, on the Mainland they have been known to pay 30-50% over market rates to secure suitable premises."

real estate for investment purposes, and insurance companies were only granted limited permissions to diversify investments into real estate in 2010.

Despite this, China Taiping, China Merchants Bank, Ping An, Taikang Life, Bank of China and Bank of Communications have been amongst the biggest buyers of office units across Shanghai and Beijing in recent years, and Agricultural Bank of China and China Construction Bank have been the top buyers in Hong Kong - meaning buying-for-occupation has become a means of investment.

The nature of the property markets in these Far-Eastern financial centres also contributes to the preference for purchasing. Rents in Beijing and Hong Kong are amongst the highest in the world, lease lengths are short, and the market can change very quickly. When taken in conjunction with the expectation that they will be in China forever – and the ample coffers available to them - it is clear that purchasing for occupation has been a prudent option for Chinese financial institutions.

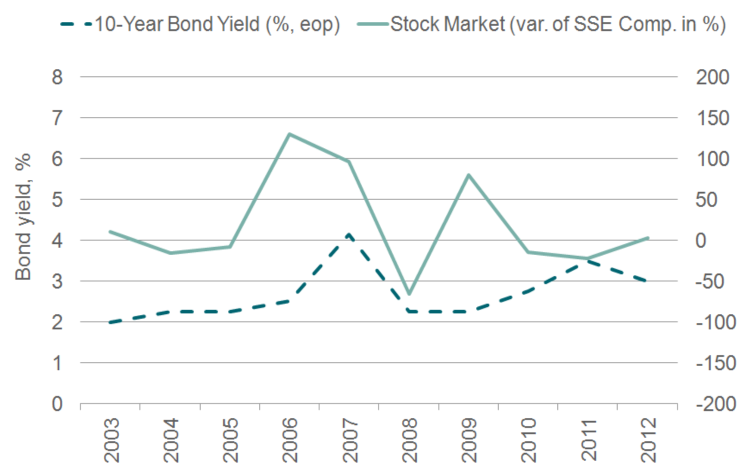
Offices taken by the biggest institutions tend to be large, new and centrally located. In June 2013 China Merchants Bank acquired a site with a buildable area of 614,000 sq ft on Beijing's Financial Street for RMB 3.9 billion (£400 million) and in 2009, Agricultural Bank of China took 916,000 sq ft at the then under-construction first phase of CITIC Pacific's Shipyard project in Pudong for RMB 3.8 billion (£390 million). It follows that Chinese financial institutions are willing to pay a premium and, on the Mainland, there have been instances where they have paid 30-50% over market rates to secure suitable premises.

Due to limited supply in the centre of China's financial districts, some banks and insurers have acquired large buildings in fringe areas - primarily because it enables them to consolidate staff and factor in future growth. However, these buildings are usually taken in conjunction with the ownership of existing buildings, or the acquisition of smaller units, in the heart of the financial district.

It is therefore clear, whether in Finance Street, Pudong, or Hong Kong Central, by means of leasing, buying, or in conjunction with a fringe office, being

GRAPH 5

China's volatile bond and equity markets



Graph source: Focus Economics

"Today we agree the next big step, by laying the ground for London to become a major global centre for the investment of RMB back into China." George Osborne, Chancellor, in an October 2013 announcement meaning Chinese banks could set up branches in the UK

in the centre of the financial district remains a must.

Why London?

Chinese financial institutions have a huge presence at home, where they have been insulated from recent economic downturns. They have been able to interact globally from subsidiaries in Hong Kong, where their assets are growing. So why would they locate HQs in London?

The primary reason for the location of HQs in London is the level of business and investment the Chinese have in western Europe. Research from the Rhodium Group shows Europe was the destination for 33% of China's foreign direct investment last year, that annual investment from China to the EU grew from less than US$1 billion annually before 2008 to more than US$10 billion in the past two years, and that investment by China can be projected to reach in excess of US$1 trillion by 2020.

According to the Heritage Foundation there has been US$17.8 billion of Chinese investment in Britain since 2005, with US$6 billion in 2012 and US$2.5 billion this year. British exports to China have doubled to £15.9 billion in the past five years and, last year, Britain was ranked fourth as a destination for Chinese investment - behind only Hong Kong, the US and Kazakhstan.

Many of China's biggest financial institutions have already begun to capitalise on increasing investment both to, and from, the west. Bank of China's UK business funds and advises Chinese corporates seeking to expand in the UK and Europe. Its investment banking arm, Bank of China International, focuses on equity broking for securities listed on the Hong Kong stock exchange to UK and European institutional investors.

Industrial and Commercial Bank of China's UK subsidiary focuses on financing trade with China, and on companies with strong China-UK links. It also plans to operate as a regional hub for new offices being opened by its parent bank in continental Europe, Latin America and the Middle East.

China International Capital Corporation's UK arm serves European clients looking to do business with China, as well as providing a platform from which it can serve its Chinese client base, and Agricultural Bank of China's UK subsidiary focuses on providing financial solutions to Chinese companies investing in the UK, as well as to British companies investing in China.

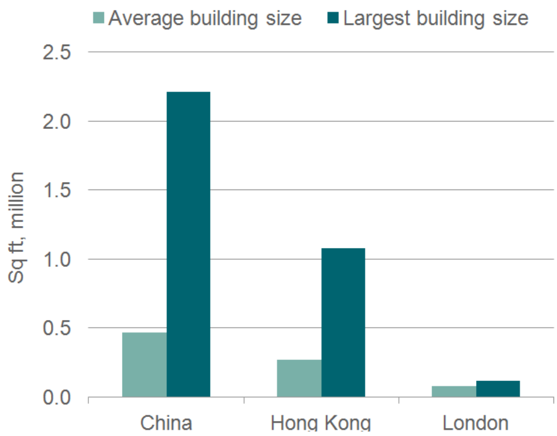
Since the economic downturn, UK regulators have been tougher on financial institutions. But where restrictions are tight, Chinese banks have put pressure on UK regulatory bodies to loosen them, reflecting their desire to operate more freely from London.

An October 2012 letter to the UK Treasury, for instance, highlighted Chinese banks' discontentment at not being allowed to set up branches in London (at present, their UK subsidiaries are regulated in the same way as local banks – with tight standards on transparency, capital cushions and liquidity buffers. In contrast, branches constitute extended arms of overseas banks, meaning control is limited) a year later, in October 2013, George Osborne announced plans to allow Chinese banks to set up wholesale branches in the UK.

Banks already located here have had a limited impact on the central London office market: Bank of China purchased One Lothbury (118,000 sq ft) in 2009 for £82 million, Industrial and Commercial Bank of China acquired 81 King William ➔

GRAPH 6

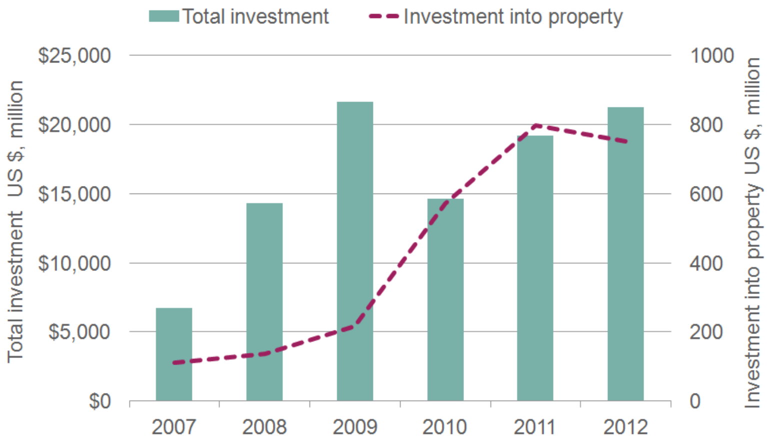
Purchases for occupation by Chinese financial institutions



Graph source: Savills

GRAPH 7

Chinese investment into Europe



Graph source: The Heritage Foundation, RCA

Street (39,000 sq ft) in 2010 for £16.5 million, and China International Capital Corporation currently leases 11,000 sq ft at 125 Old Broad Street.

Smaller occupiers include Agricultural Bank of China and Bank of Communications, who each lease sub-10,000 sq ft units at One Bartholomew Lane, and China Construction Bank, who lease a sub-10,000 sq ft unit at Canary Wharf.

Although these institutions are not major occupiers at present, the building blocks are in place for their global expansion and - as investment into western Europe increases - it is inevitable that the presence of Chinese financial institutions in the City will grow.

Conclusion

■ Total Chinese investment into Europe, including investment into real estate, is projected to reach more than US$1 trillion by 2020.

■ We estimate Chinese financial institutions could take in excess of 2 million sq ft in the City of London during this period.

■ Two of China's largest banks have already purchased HQs close to the Bank of England, and the purchasing of prime units in the financial district is set to continue as institutions already located here, but yet to purchase HQs, do so.

■ This means China Construction Bank, China International Capital Corporation, Agricultural Bank of China and Bank of Communications are likely to be the next organisations to purchase office units in the City - these big banks will be followed by smaller institutions, and those from China's less developed financial sectors.

■ The largest businesses will seek freehold opportunities and buildings chosen by them will be new, or substantially refurbished. Landlords willing to tailor turnkey developments to meet the requirements of Chinese financial institutions will be in a particularly good position to benefit, and limited options to buy in the City core could create demand in fringe locations.

■ Less developed institutions not currently occupying space in the City will initially lease units at high specification premises. Target buildings are likely to be located around the Bank of England, with insurers preferring close proximity to the Lloyds Building. These tenants will be a good source of demand for landlords marketing units within newly refurbished and developed premises in the financial and insurance district.

■ Chinese financial occupiers are used to short leases at home, and a number of institutions initially leasing space in the City will have a longer term plan to purchase. This means landlords who are willing to be flexible could benefit in the short term.

■ Rents and purchase prices paid by Chinese financial institutions are likely to be high. China Merchants Bank recently acquired a development in Beijing's Financial Street for RMB 3.9 billion (£400m). A sum that would have bought 30 Gresham Street (£335 million), 5 Canada Square (£383 million) or the Lloyds Building (£260 million).

■ Furthermore, in Hong Kong, Chinese financial institutions are amongst those paying the highest rents in the world - meaning occupation of high floors in the City of London's most prestigious buildings is a likely possibility.

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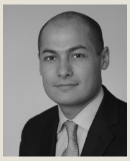

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