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Scaling the Great Wall: An Analysis of Foreign Banks' Entry into China

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I. INTRODUCTION

In 2003, China posted its highest economic growth rate in seven years, a robust 9.1%.\footnote{1} Even though some predict this rapid growth will taper off, in the third quarter of 2004 China's economy still grew at a rate of 9.1%\footnote{2}. The opportunities implied by China's continued economic growth, combined with China's vast population\footnote{3} and high national saving rate,\footnote{4} provide a tantalizing market to the international financial services industry.

When China joined the World Trade Organization (WTO) in late 2001, it promised to gradually open the banking sector to overseas participation over a five-year period, and fully liberalize its banking sector by December 11, 2006.\footnote{5} Aiming at the huge market beyond 2006, foreign financial institutions are enthusiastic about gaining greater market access during the phase-out period.\footnote{6} In fact, competition is already heating up, with Hongkong & Shanghai Banking Corp. (HSBC), Standard Chartered, and Citigroup Inc. having operated in...
China. After a brief introduction to the Chinese banking system, Part II describes the role of foreign banks in the Chinese banking sector and gives a brief history of foreign banks’ operation in China. Part III discusses the four primary entry forms that foreign banks may take under the current regulatory framework. Part IV identifies the opportunities and the challenges facing foreign banks before the full liberalization of the Chinese banking sector in late 2006. Part V concludes the article and recommends two commercially viable entry forms during the transition period.

II. FOREIGN BANKS IN THE CHINESE BANKING SECTOR

Currently, the Chinese banking system is made up of two regulatory institutions, four state-owned commercial banks, three policy banks, eleven joint stock commercial banks, more than one hundred and ten city/urban commercial banks, more than one thousand urban credit cooperatives, and more than thirty-five thousand rural credit cooperatives providing basic banking services. (Table I)

The State Council (the cabinet) ultimately oversees the two regulatory institutions—the People’s Bank of China (PBC) and the China Banking and Regulatory Commission (CBRC). The PBC is China’s central bank, which formulates and implements monetary policy, maintains the banking sector’s payment, clearing, and settlement systems.

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9. See infra notes 13-55 and accompanying text.

10. See infra notes 56-157 and accompanying text.

11. See infra notes 158-95 and accompanying text.

12. See infra notes 196-209 and accompanying text.


systems, and manages official foreign exchange and gold reserves.\textsuperscript{15} The CBRC was established in April 2003 to take over the supervisory and regulatory role of the banking sector.\textsuperscript{16} It is responsible for "the regulation and supervision of banks, asset management companies, trust and investment companies as well as other deposit-taking financial institutions."\textsuperscript{17}

The four State-Owned Commerical Banks ("Big Four") represent 59\% of the banking assets and operate a vast nation-wide branch network.\textsuperscript{18} "The Big Four have undergone a transformation away from their original policy-lending mandate toward commercial lending," but the process is yet to be completed.\textsuperscript{19} Nonperforming loans (NPLs), due largely to legacy bad loans, remain high and lead to a lower return on assets compared with other domestic banking institutions.\textsuperscript{20}

The three Policy Banks were established in 1994 to relieve the Big Four of the policy-lending activities.\textsuperscript{21} Policy lending banks fund themselves through central bank loans, government deposits and the issuance of government-guaranteed deposits held by commercial banks.\textsuperscript{22} Since their establishment, these Policy Banks have remained poor overall performers and have not achieved their intended objective of impacting positively on the performance of the Big Four.\textsuperscript{23}

Joint stock commercial banks are incorporated as Joint Stock Limited Companies under The People's Republic of China Company Law.\textsuperscript{24} "They have made inroads particularly into the small and medium enterprise loan market," which is essential for laying a firm foundation for the market economy in China.\textsuperscript{25} "They also tend to be

\begin{itemize}
\item[16.] See id. at 11.
\item[17.] See Hansakul, supra note 14, at 8.
\item[18.] See Barth et al., supra note 15, at 7, 9.
\item[20.] Hansakul, supra note 14, at 1.
\item[21.] Shirai, supra note 19, at 50-51.
\item[22.] See id. at 92.
\item[23.] Id.
\item[24.] Hansakul, supra note 14, at 4.
\item[25.] Id.
\end{itemize}
more profitable,” recording higher Return on Average than the Big Four.26

City/Urban Commercial Banks have been created by restructuring and consolidating Urban Credit Cooperatives.27 Due to their history, mandate and capital strength, the scope of City/Urban Commercial Banks’ business tends to be concentrated in the city where they are located, thus they are unable to operate on their own on a national or regional scale, unlike the Joint Stock Commercial Banks.28 This is a major comparative disadvantage for their future expansion.

“Credit cooperatives typically provide credit to small and medium-sized rural or urban enterprises and individuals.”29 Due to their collective-ownership status, both types of credit cooperatives are subject to state control, thus their loan extension is still influenced by local policy considerations.30

Foreign banks currently account for around 1% of total bank assets.31 By the end of August 2004, foreign banks had established two hundred and sixteen representative offices and two hundred operational entities in China, including one hundred and sixty-two branches and fourteen subsidiaries or joint venture entities.32 “Thirteen foreign banks are now permitted to engage in Internet banking, and five foreign bank branches are permitted to offer custodian services for securities transactions for qualified foreign institutional investors (QFII).”33 Foreign banks may offer around one hundred products under twelve broad categories of business activities.34 In addition, foreign financial institutions, including Citibank, HSBC, Hang Seng Bank, and the IFC and GIC of Singapore have already taken equity stakes in the Chinese banks.35

26. Id.
27. Herrero & Santabárbara, supra note 13, at 11.
28. Id.
29. Id.
30. Id.
31. Hansakul, supra note 14, at 5.
33. Id.
34. Id.
35. Id.
Table I: Structure of Chinese Banking System

**Regulatory Institutions**

<table>
<thead>
<tr>
<th>The People’s Bank of China (PBC)</th>
<th>China Banking Regulatory Commission (CBRC)</th>
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</table>

**Banking Institutions**

- **State-Owned Commercial Banks**
  - Agricultural Bank of China
  - Bank of China
  - China Construction Bank
  - Industrial and Commercial Bank

- **Policy Lending Banks**
  - Agriculture Development Bank of China
  - Export Import Bank of China
  - China Development Bank

- **Other Commercial**
  - Joint Stock Commercial Banks (11)
  - City/Urban Commercial Banks (112)

- **Credit Cooperatives**
  - Rural Credit Cooperatives (around 35,000)
  - Urban Credit Cooperatives (around 1,000)

- **Foreign Banks**
  - Branches
  - Wholly Foreign-Owned Banks
  - Joint Venture Banks

Foreign banks have a long history in China.\(^{36}\) The first foreign bank was established in China in 1845.\(^{37}\) After the founding of the People’s Republic of China in 1949 and the “Socialist Transformation” in 1952, foreign banks were deprived of their privileges and most

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37. *Id.* at 6.
foreign banks left China.\textsuperscript{38} The open\textsuperscript{39} and reform policy beginning in 1978 marked the beginning of a new era in China's contemporary economic history.\textsuperscript{40} The process of permitting a greater role for foreign banks in the Chinese banking sector has been a gradual one.\textsuperscript{41}

Initially, foreign banks entered China in the form of representative offices, which meant they were unable to undertake profit-making activities.\textsuperscript{42} They were also geographically confined to Beijing and the Special Economic Zones.\textsuperscript{43} In 1982, the first new branch of a foreign bank was set up in the Special Economic Zone of Shenzhen.\textsuperscript{44} The branch was allowed to engage in profit-making activities including loans, deposits, guarantees, and remittances in foreign currency and to foreign entities.\textsuperscript{45} Geographical restrictions were gradually relaxed in the late 1980s, and foreign financial institutions began to operate in other inland cities such as Tianjin, Nanjing and Fuzhou.\textsuperscript{46}

In 1996, for the first time, selected foreign banks were permitted to provide Chinese currency RMB\textsuperscript{47} business to foreign individuals and

\begin{itemize}
  \item \textsuperscript{38} See id. at 6 (noting that four foreign banks remained in Shanghai - the HSBC, the Chartered Bank, the Bank of East Asia and the Overseas-Chinese Bank).
  \item \textsuperscript{39} China's late leader, Deng Xiaoping, initiated a major reform, known as the Open/Open Door Policy, to open up the once closed Chinese economy to the world and introduce market forces to the centrally-planned economy in 1978. See Hansakul, supra note 14 at 3 n.1.
  \item \textsuperscript{40} HUANG, supra note 36, at 6.
  \item \textsuperscript{41} Id.
  \item \textsuperscript{42} See Measures on the Administration of Foreign-capital Financial Institutions' Representative Offices in China, art. 2 (June 27, 2002), LEXIS, PRCLEG 2406 (defining the scope of Representative Offices as engaging in non-operation activities such as consultancies, contacts and market investigations, etc).
  \item \textsuperscript{43} See Resolution of the Standing Committee of the National People's Congress Approving the Regulations on Special Economic Zones in Guangdong Province, arts. 1-3 (Aug. 26, 1980), LEXIS, PRCLEG 15. Special Economic Zones (SEZs) are development zones established by the PRC to encourage foreign investment in China, bringing much needed jobs, technical knowledge, and future tax revenues in return for significant tax concessions at start-up of the operations and over a number of years. Id.
  \item \textsuperscript{44} See HUANG, supra note 36, at 10 (citing Almanac of China's Finance and Banking 1995).
  \item \textsuperscript{46} Id.
  \item \textsuperscript{47} See CENTRAL INTELLIGENCE AGENCY, supra note 1, at 116. Chinese currency is known as Renminbi ("RMB"). Id. Its basic unit is Yuan. Id. The exchange rate today is: $1=RMB 8.2765 (last visited Feb. 11, 2005). See Federal Reserve Bank of New York, Foreign Exchange rates, http://www.ny.frb.org/markets/fxrates/noon.cfm.
\end{itemize}
enterprises in a pilot project in Shanghai.\textsuperscript{48} This scheme gradually expanded, and at the time of WTO entry in 2001 there were thirty-one foreign banks approved to offer such services, of which twenty-three were located in Shanghai and eight in Shenzhen.\textsuperscript{49}

Table II. WTO Phase In for RMB services by geographic location and type of business

<table>
<thead>
<tr>
<th>By geography</th>
<th>Foreign banks can begin to offer services in domestic currency to</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Foreign companies &amp; foreign individuals</td>
</tr>
<tr>
<td>Open Shanghai, Shenzhen</td>
<td>1996</td>
</tr>
<tr>
<td>Open Tianjin, Dalian</td>
<td>2001</td>
</tr>
<tr>
<td>Open Guangzhou, Qingdao, Nanjing, Wuhan</td>
<td>2002</td>
</tr>
<tr>
<td>Open Jinan, Fuzhou, Chengdu, Chongqing</td>
<td>2003</td>
</tr>
<tr>
<td>Open Kunming, Zhuhai, Beijing, Xiamen</td>
<td>2004</td>
</tr>
<tr>
<td>Open Shantou, Ningbo, Shenyang, Xian</td>
<td>2005</td>
</tr>
<tr>
<td>Lift all geographical restrictions</td>
<td>2006</td>
</tr>
</tbody>
</table>


WTO accession committed China to greatly expanding the business scope of foreign banks.\textsuperscript{50} (Table II shows the time schedule for the opening-up to foreign competition by geographic location and type of business) Upon accession, China cancelled geographical and client limitations for approved foreign banks in handling foreign exchange business.\textsuperscript{51} Accession also meant that in the first wave of financially

\textsuperscript{48} Laurenceson, supra note 45, at 5-6.
\textsuperscript{49} Id. at 6.
\textsuperscript{50} See Hong Kong Trade Development Council, supra note 5.
\textsuperscript{51} See id.; see also Louise do Rosario, All Uphill for Foreign Banks, THE BANKER, Nov. 2003, at 81 (noticing China undertook its WTO commitment in a timely manner).
open cities, approved foreign banks were able to provide RMB services to foreign companies and individuals. One of the most significant events since WTO entry occurred in late 2003 when foreign banks that held a RMB license were permitted to apply to handle RMB business with Chinese enterprises in the thirteen cities that had been declared financially opened by this time. In January 2004 four foreign banks—Citibank, SBC, Mizuho Bank from Japan and Hong Kong-based Bank of East Asia—were given approval to begin such business.

III. REGULATIONS GOVERNING FOREIGN BANKS IN CHINA

Under the current Chinese regulatory scheme, foreign financial institutions may take the following four major forms to enter the Chinese banking sector: (1) banks registered in China and wholly owned by foreign investors ("Wholly Foreign-Owned Banks"); (2) Sino-foreign joint equity banks registered in China ("Joint Venture Banks"); (3) branches of foreign banks ("Foreign Bank Branches"); and (4) acquisition of equity stake in Chinese domestic banks ("Ownership in Chinese banks"). The first three types of banks are referred to collectively as "foreign banks" and are regulated under the Regulations of the People's Republic of China on the Administration of Foreign-Funded Financial Institutions and relevant Implementation Rules. The fourth type is regulated under Measures for the

52. See Table II, supra p.106. Only in the designated financial “open cities” could foreign banks do business. See Supra note 39.
53. See Hong Kong Trade Development Council, supra note 5.
56. See Regulations of the People's Republic of China on the Administration of Foreign-Funded Financial Institutions (Feb. 1, 2002), LEXIS, PRCLEG 2198 [hereinafter Regulations on FFFI].
58. See Regulations on FFFI, supra note 56.
Administration of the Investment and Shareholding in Chinese-Funded Financial Institutions by Overseas Financial Institutions. 59

A. Establishment of Foreign Banks

A Wholly Foreign-Owned Bank must have a minimum registered capital of RMB 300 million in freely convertible currencies. 60 To establish a Wholly Foreign-Owned Bank, the applicant must be a financial institution, 61 have established a representative office in China for at least two years prior to the application, 62 and have a year-end asset value of no less than $10 billion in the year prior to the application. 63 Further, the applicant should be located in a country or region where a sound financial supervisory system exists 64 and should meet other prudential requirements. 65 In addition, the sole shareholder or the largest shareholder of a Wholly Foreign-Owned Bank must be a commercial bank, 66 which has a capital adequacy ratio of no less than 8%. 67

A Joint Venture Bank must have a minimum registered capital of RMB 300 million in freely convertible currencies. 68 To establish a Joint Venture Bank, the foreign applicant must be a financial institution 69 with an established representative office in China, 70 and have a year-end asset value of no less than $10 billion in the year prior to the application. 71 Further, the foreign applicant should be located in a country or region where a sound financial supervisory system exists. 72

59. See Measures for Shareholding, supra note 57, art. 2.
60. Regulations on FFFI, supra note 56, art. 5.
61. Id. arts. 6(1) & 8(1).
62. Id. art. 6(2).
63. Id. art. 6(3).
64. Id. art. 7(3).
65. Id. art. 6(6).
66. See Detailed Rules for the Implementation of the Regulation of the People’s Republic of China on the Administration of Foreign-funded Financial Institutions (Sept. 1, 2004), LEXIS, PRCLEG 3665, arts. 6 & 7 [hereinafter Detailed Rules on FFFI].
67. Id. art. 6. Capital adequacy ratio in this Note refers to the ratio between equity and total assets. See BLACK’S LAW DICTIONARY 223 (8th ed. 2004).
68. Regulations on FFFI, supra note 56, art. 5.
69. Id. art. 8(1).
70. Id. art. 8(2).
71. Id. art. 8(3).
72. Id. art. 8(4).
and should meet other prudential requirements. In addition, the sole foreign shareholder or the largest foreign shareholder of a Joint Venture Bank must be a commercial bank, which has a capital adequacy ratio of no less than 8%. The head office of a Foreign Bank Branch must transfer, in freely convertible foreign currency, non-repayable working capital of no less than RMB 100 million to the Branch. To establish a Foreign Bank Branch, the foreign bank should have established a representative office in China for at least two years prior to the application, having a year-end asset value of no less than $20 billion, and having a capital adequacy ratio of no less than 8%. Further, the foreign bank should be located in a country or region where a sound financial supervisory system exists and should meet other prudential requirements. Notably, the prior one-year waiting period for setting up additional branches was repealed by the Detailed Rules of 2004.

B. Application Procedure

To establish a Wholly Foreign-Owned Bank or a Foreign Bank Branch, the foreign applicant should present, in addition to the usual application documents concerning the entity in question, a feasibility study, the article of association of the proposed entity, a copy of the business license of the applicant, an opinion letter regarding the application issued by its home financial supervisory authority, the

73. Id. art. 6(6).
74. Detailed Rules on FFFI, supra note 66, art. 7.
75. Id.
76. Regulations on FFFI, supra note 56, art. 5.
77. Id. art. 7(1).
78. Id. art. 7(2).
79. Id. art. 8(4).
80. Id. art. 6(6).
81. See Detailed Rules for the Implementation of the Regulation of the People’s Republic of China on the Administration of Foreign-funded Financial Institutions, repealed, LEXIS, PRCLEG 2262, art. 14 [hereinafter Repealed Detailed Rules on FFFI].
82. Regulations on FFFI, supra note 56, arts. 9(1) & 10(1).
83. Id. arts. 9(2) & 11(2). The feasibility report should include the analysis of the market prospect of the institution to be established, its business development plan in China, debt and profit projection for the next three years after the start of the business. See Detailed Rules on FFFI, supra note 66, art. 10.
84. Regulations on FFFI, supra note 56, art. 9(3).
85. Id. arts. 9(4) & 10(3).
annual reports of the applicant for the previous three years, complete information about the financial system, including relevant financial laws and regulations of the country or region where the head office of the applicant is domiciled, and information on the organizational network and main shareholders of the applicant. To establish a Joint Venture Bank, all the investors (including foreign banks and Chinese domestic banks) should jointly present, in addition to the above-mentioned documents regarding a foreign applicant, all the relevant information about the Chinese domestic applicant. All the materials, except for the annual report, must have a Chinese translation attached if they are written in a foreign language. The annual report must be audited and have a Chinese or English version attached if it is in other languages.

An applicant should present the required documents directly to the CBRC, and also send a copy to the CBRC local office. The CBRC should decide whether to accept or decline the application within six months after the receipt of a completed application. The applicant should get a formal application form from a local CBRC office within fifteen days of the notice of acceptance and start the preparation work. Failing to get the formal application form within fifteen days of notice will prevent the applicant from reapplying for one year. The applicant should complete the preparation work within six months. This period may be extended for three months with the approval of a CBRC local office for good cause shown. The applicant must apply for extension one month prior to the expiration of the preparation period.

After the preparation work is completed, the applicant should submit the formal application form with other required documents to the

86. Id. arts. 9(5) & 10(4).
87. Detailed Rules on FFFI, supra note 66, art. 14(1).
88. Id. art. 14(3).
89. Regulations on FFFI, supra note 56, art. 11.
90. Id. art. 12; Detailed Rules on FFFI, supra note 66, art. 15.
91. Detailed Rules on FFFI, supra note 66, art. 13.
92. Id. art. 20.
93. Id. art. 21.
94. Id.
95. Id. art. 29.
96. Id. art. 21.
97. Regulations on FFFI, supra note 56, art. 14.
98. Detailed Rules on FFFI, supra note 66, art. 24.
CBRC local office. After a preliminary examination by the local office, the documents will be submitted to the CBRC directly for final approval. Within two months after the receipt of the formal application documents, the CBRC must decide whether to approve or not to approve the application.

Once approved, the applicant should apply for examination prior to the formal operation to the CBRC local office. After passing the examination of the local office, the applicant can get a permit for conducting financial business from the CBRC. The foreign bank should, before starting operation, make public announcements on the national and local newspapers designated by the CBRC and start operations within three months after the approval of the CBRC.

C. Business Scope

Foreign banks may engage in all kinds of foreign currency business, including deposits, loans, discounts, approved investments, guarantees, foreign exchange dealings, foreign trade settlements, remittances, and bank cards, as well as providing custodian, credit checking, and consultation services. The geographic location and scope of conducting the Chinese currency RMB business by foreign banks is decided by the CBRC.

To engage in RMB business, a foreign bank must have had its business operation in China for more than three years prior to the application. Its business operation in China must have been profitable for the two consecutive years prior to the application. It must meet other prudential supervisory requirements required by the CBRC.

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99. Id. art. 25.  
100. Id.  
101. Id. art. 26.  
102. Id. art. 27.  
103. Id.  
104. Detailed Rules on FFFF, supra note 66, art. 28.  
105. Id. art. 29.  
106. See Regulations on FFFF, supra note 56, art. 17.  
107. Id. art. 19. Currently, foreign banks can only conduct RMB business in the thirteen cities approved by the CBRC. See People's Daily, supra note 54.  
108. Regulations on FFFF, supra note 56, art. 20(1).  
109. Id. art. 20(2).  
110. Id. art. 20(3).
The registered capital of a Wholly Foreign-Owned Bank or a Joint Venture Bank must be no less than RMB 600 million if it provides RMB business to Chinese domestic enterprises. The registered capital must be no less than RMB 1 billion if it provides RMB business to Chinese individual customers. The working capital of a Foreign Bank Branch must be no less than RMB 300 million if it provides RMB business with Chinese domestic enterprises, the working capital must be no less than RMB 500 million if it conducts RMB business with individual Chinese customers.

Foreign banks cannot underwrite securities or act as securities or insurance agents. They may, however, invest in government bonds, financial bonds, and other foreign currency securities other than stocks. In addition, foreign financial institutions may be granted QFII status to invest in the Chinese A-share market. Foreign Bank Branches are also permitted to offer custodian services for securities transactions for QFII.

D. Business Control Ratios

Foreign Banks must also satisfy several capital ratios. A Foreign Bank Branch should have 30% of its working capital maintained in certain interest-bearing accounts designated by PBOC, including deposits in PBOC designated banks. The fixed assets of a Wholly Foreign-Owned Bank or a Joint Venture Bank should not

111. Detailed Rules on FFFI, supra note 66, art. 35(2).
112. Id. art. 36(2).
113. See Classification of Accounts and Accounting Statements of Foreign Investment Industrial Enterprises (May 25, 1992), LEXIS, PRCLEG 209 (defining “net working capital” as “the total current assets minus current liabilities”).
114. Detailed Rules on FFFI, supra note 66, art. 35(1).
115. Id. art. 36(1).
117. Regulations on FFFI, supra note 56, art. 17(4).
119. M. Liu, supra note 32.
120. See infra notes 120-28 and accompanying text.
121. Regulations on FFFI, supra note 56, art. 24.
exceed 40% of its equity capital.\textsuperscript{122} The capital adequacy ratio for a Wholly Foreign-Owned Bank or a Joint Venture Bank should be no less than 8%.\textsuperscript{123} A Wholly Foreign-Owned Bank or a Joint Venture Bank should not make loans to a single borrower or its affiliates in an amount of more than 25% of capital except when special permission is granted.\textsuperscript{124} The liquidity ratio (liquidity assets/liquidity liabilities) of foreign banks should be no less than 25%.\textsuperscript{125} The foreign currency deposits taken from China should not exceed 70% of the foreign bank’s foreign currency assets in China.\textsuperscript{126} For a Wholly Foreign-Owned Bank or a Joint Venture Bank, the ratio of RMB capital to RMB risk-weighted assets must not be less than 8%.\textsuperscript{127} For a Foreign Bank Branch, the ratio of its RMB working capital plus reserve funds to RMB risk-weighted assets must not be less than 8%.\textsuperscript{128}

E. Management Requirement

The chairman, president, and general manager of foreign banks must be approved by the head office of the CBRC.\textsuperscript{129} Other members of the senior management (deputy presidents, deputy general managers) are approved by the CBRC local offices.\textsuperscript{130} The change of a general manager of a Foreign Bank Branch is approved by the local offices of the CBRC.\textsuperscript{131} After receiving the application for approval of the president or general manager of a foreign bank, the CBRC may interview the president or general manager candidates.\textsuperscript{132} In general, a tenure of at least two years and detailed qualifications are also stipulated.

\textsuperscript{122} Id. art. 27.
\textsuperscript{123} Id. art. 25.
\textsuperscript{124} Id. art. 26.
\textsuperscript{125} Id. art. 29.
\textsuperscript{126} Id. art. 30.
\textsuperscript{127} Regulations on FFFI, supra note 56, art. 28. Risk-weighted assets are calculated by assigning each asset and off-balance sheet item to one of four broad risk categories. See Lisa L. Broome & Jerry W. Markham, Regulation of Bank Financial Service Activities 585-86 (2d ed. 2004).
\textsuperscript{128} Regulations on FFFI, supra note 56, art. 28.
\textsuperscript{129} Detailed Rules on FFFI, supra note 66, art. 56.
\textsuperscript{130} Id.
\textsuperscript{131} Id.; cf. Repealed Detailed Rules on FFFI, supra note 81, art. 54 (providing that the change of general manager of foreign bank branches be approved by the head office of the PBC).
\textsuperscript{132} Detailed Rules on FFFI, supra note 66, art. 58.
for members of the senior management of foreign banks and branches.  

F. Reporting

Foreign banks are required to report promptly to the CBRC local offices regarding the specifically listed major issues in addition to the regular reports on internal auditing, business management, and statistics. These requirements include: 1) severe problems concerning financial situation or business activities of the foreign banks and branches or their parent office; 2) change of articles of association, registered capital, registered address, or chief officers; 3) reorganization, merger or divestiture of their parent office; and 4) any major change of supervisory rules in the place of incorporation of the parent bank. In the case of any suspension of business operating, the CBRC local offices should be notified seven working days prior to any such suspension, except for suspension due to force majeure.

G. Tax Treatment

Foreign banks’ earnings from foreign currency enjoy the preferential tax treatment granted to all the foreign-invested enterprises. That is, foreign banks in Special Economic Zones enjoy a corporate income tax rate of 15%. Some foreign banks are even exempted, commencing from their first profit-making year, from

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133. Id. arts. 52-54, 59.
134. Regulations on FFFI, supra note 56, art. 34.
135. Detailed Rules on FFFI, supra note 66, art. 91(1)-(7).
136. Id. art. 91(8).
139. See id. art. 73(3).
140. Those foreign banks that have working capital of at least $10 million and a period of operations of at least ten years enjoy this tax benefit. See id. art. 75(5).
corporate income tax in the first year and subject to corporate income tax at a rate reduced by one half for the second and third years.\textsuperscript{141}

H. Foreign Financial Institutions' Equity Participation in Chinese Banks and Non-Bank Financial Institutions

In addition to being able to establish Foreign Banks in China, foreign financial institutions\textsuperscript{142} are permitted to invest in Chinese financial institutions.\textsuperscript{143} To qualify for investment in Chinese financial institutions, a foreign financial institution must have total assets of $10 billion if the investment is in a commercial bank; total assets of $1 billion if the investment is in an urban or rural credit cooperative; and total assets of $1 billion if the investment is in a nonbank financial institution.\textsuperscript{144} The foreign financial institution must have been profitable for the previous two years.\textsuperscript{145} If the foreign financial institution is a commercial bank, it should have a capital adequacy ratio of at least 8%;\textsuperscript{146} if it is a nonbank financial institution, it should have a total capital of no less than 10\% of total risk-weighted assets.\textsuperscript{147} The financial institution should have a good long-term credit rating for the previous two years from an international rating agency recognized by the CBRC.\textsuperscript{148} Further, the foreign financial institution should be domiciled in a country or region where a sound financial supervisory system exists and economic status is satisfactory,\textsuperscript{149} and should meet other prudential requirements.\textsuperscript{150}

As to the maximum equity that a foreign financial institution may take in a Chinese financial institution, a single foreign investor

\begin{itemize}
\item \textsuperscript{141} Id.
\item \textsuperscript{142} Foreign Financial Institutions include foreign-registered financial holding companies, commercial banks, securities companies, insurance companies, funds and other financial institutions recognized by the CBRC. See Measures on Shareholding, supra note 57, art. 2.
\item \textsuperscript{143} Chinese Financial Institutions include Chinese registered commercial banks, urban credit cooperatives, rural credit cooperatives, trust investment companies and other Chinese financial institutions recognized by the CBRC. See id.
\item \textsuperscript{144} Id. art. 7(1).
\item \textsuperscript{145} Id. art. 7(2).
\item \textsuperscript{146} Id. art. 7(4).
\item \textsuperscript{147} Id.
\item \textsuperscript{148} Measures on Shareholding, supra note 57, art. 7(2).
\item \textsuperscript{149} See id. art. 7(6) & (7).
\item \textsuperscript{150} Id. art. 7(8).
\end{itemize}
may acquire up to 20% of the equity of a Chinese institution.\textsuperscript{151} So long as the equity share of the total foreign investment in a financial institution is lower than 25%, the nature and business scope of the targeted institution remains unchanged.\textsuperscript{152} If foreign investors altogether acquire 25% or more of an unlisted Chinese financial institution’s total equity, that institution will be treated as a Foreign Financial institution.\textsuperscript{153} If foreign investors altogether acquire more than 25% of the total equity in a listed financial institution, however, it will continue to be treated as a domestic financial institution.\textsuperscript{154}

The Chinese financial institution that accepts an investment from a foreign financial institution should apply to the CBRC if the Chinese financial institution is a State-Owned Commercial Bank, a Joint Stock Commercial Bank, or a nonbank financial institution that is directly supervised by the CBRC.\textsuperscript{155} All the other Chinese financial institution applicants should apply to the provincial agency of the CBRC, and that agency shall submit the application to the CBRC for approval after a preliminary examination.\textsuperscript{156} The foreign financial institution must transfer the capital in full to the account of the Chinese financial institution within sixty business days of receiving the approval of the CBRC.\textsuperscript{157}

IV. OPPORTUNITIES AND CHALLENGES FOR FOREIGN BANKS IN CHINA

Since China’s WTO entry, Foreign Banks have been able to gradually expand their market access in China.\textsuperscript{158} China has abided by its WTO promises, winning praise for doing so on time and in a transparent manner.\textsuperscript{159}

First, it has lowered the capital requirements on foreign banks to

\begin{footnotesize}
\begin{enumerate}
\item[151.] Id. art. 8.
\item[152.] M. Liu, \textit{supra} note 32.
\item[153.] \textit{See} Measures on Shareholding, \textit{supra} note 57, art. 9.
\item[154.] Id. art. 9.
\item[155.] Id. art. 10(1).
\item[156.] Id. art. 10(2).
\item[157.] Id. art. 13.
\item[158.] M. Liu, \textit{supra} note 32.
\end{enumerate}
\end{footnotesize}
conduct RMB business.\textsuperscript{160} The minimum working capital of a Foreign Bank Branch doing RMB business with Chinese enterprises has dropped from RMB 400 million\textsuperscript{161} to RMB 300 million.\textsuperscript{162} The required capital for a Foreign Bank Branch to do business with Chinese individual customers has dropped from RMB 600 million\textsuperscript{163} to RMB 500 million.\textsuperscript{164}

Second, it cancelled the one-year waiting period\textsuperscript{165} on foreign banks to open new branches, providing foreign banks more freedom in scheduling their own business expansions.\textsuperscript{166}

Third, it streamlined the application process by allowing the application documents to be first submitted to the corresponding CBRC local office for preliminary review and then directly to the CBRC headquarters for final approval.\textsuperscript{167} Previously, the application materials were subject to a level-by-level examination and approval.\textsuperscript{168} The new rule cuts out the mid-level review.\textsuperscript{169} In addition, the Regulations and the Rules set a time limit for the regulator to approve or reject such an application, which was perceived as an improvement compared to the "no time limits" for regulators to approve as to domestic bank applicants.\textsuperscript{170}

Fourth, the maximum equity share of a single foreign financial institution in a Chinese financial institution was increased from 15% to the current 20%.\textsuperscript{171}

Last but not least, Foreign Banks enjoy super-national tax

\begin{footnotesize}
\begin{enumerate}
\item See infra notes 161-64 and accompanying text.
\item See Repealed Detailed Rules on FFFI, supra note 81, art. 35(1).
\item See supra note 113 and accompanying text.
\item See Repealed Detailed Rules on FFFI, supra note 81, art. 36(1).
\item See supra note 114 and accompanying text.
\item See Repealed Detailed Rules on FFFI, supra note 81, art. 14.
\item See Detailed Rules on FFFI, supra note 66, art. 25.
\item See Repealed Detailed Rules, supra note 81, art. 24.
\item See Detailed Rules on FFFI, supra note 66, art. 25.
\item See Huang, supra note 36, at 27 (noting the time limit regarding the application of foreign banks is advantageous over their Chinese domestic counterparts).
\item See Measures on Shareholding, supra note 57, art. 8; see also Noah J. Smith, International Banking: Foreign Investors Can Take 25% Equity in Chinese Banks, Chief Regulator Says, 81 Banking Rep. (BNA) 337 (Sept. 8, 2003).
\end{enumerate}
\end{footnotesize}
preferential treatment in China. While Chinese domestic banks are subject to a 33% corporate income tax rate, foreign banks in China enjoy preferential tax treatment at a reduced rate of 15% in Special Economic Zones. This is an obvious advantage for Foreign Banks over Chinese domestic banks.

Although foreign banks have benefited from the liberalization of the Chinese banking sector, they still face significant market access restrictions during the phase-out period. Several factors have been put forward to explain why foreign banks have yet to become significant players in China’s domestic financial sector.

First, Foreign Banks are still subject to geographic and product limitations. Through 2004, foreign banks were not able to provide RMB services to either foreign or domestic entities in most cities in China. This means they remain segmented from the 1.3 billion-person, $1.4 trillion local-currency savings market. Unlike in the United States, where financial institutions operate under the Gramm-Leach-Bliley Model, Chinese financial institutions operate under a separate business model, in which a commercial bank cannot conduct investment banking business or insurance business. Although scholars have been discussing the feasibility of operating Chinese financial industry under the mixed model, it seems likely that Chinese financial industry will continue to operate under the separate business model in the near future.

Second, impediments to licensing still exist. In principle, WTO accession permits licensed foreign banks to engage in local currency business within approved geographic areas in China. In practice, however, licenses have been granted only after long

172. See supra notes 137-41 and accompanying text.
173. See Detailed Rules on Taxation, supra note 138, art. 73(3).
174. See supra notes 137-41 and accompanying text.
175. See infra notes 176-95 and accompanying text.
176. See infra notes 177-81 and accompanying text.
177. See Table II, supra p.106.
178. See Stephens, supra note 4, at n.5.
182. See infra notes 183-85 and accompanying text.
183. See Table II, supra p.106.
qualification periods, and even then carry restrictions that seriously impede business development.

Third, Foreign Banks are subject to onerous reporting requirements. They must report both to the local CBRC branch and to their offshore headquarters. The Rules require that all the materials, except for the annual report, must have a Chinese translation, and the annual report must be audited and have a Chinese or English version attached. This requires reporting in two languages and applying two countries' accounting rules, which is again time-consuming and costly.

Fourth, regulatory transparency still needs to improve. Since its creation in 2003, the CBRC has improved regulatory transparency and its supervisory skills over Foreign Banks doing business in China. Regulatory transparency, however, may still be an issue facing Foreign Banks in China. For instance, the Regulations and the Rules use the general terms "satisfy other requirements required by the CBRC," and Foreign Banks have to refer to other rules, notices, circulars, and even press releases by the CBRC to figure out what the

184. See Detailed Rules on FFFI, supra note 66, art. 21. For instance, the preliminary approval period for an application of establishing a Foreign Bank is six months, which is a long time according to U.S. standard. Id.

185. See supra notes 109, 145 and accompanying text. For instance, foreign banks are subject to profitability requirements in order to attain licensing, requirements that are extremely difficult to attain without the desired local currency license. See Rosario, supra note 51, at 80.

186. See infra notes 187-90 and accompanying text.

187. See supra notes 90-91 and accompanying text.

188. Regulations on FFFI, supra note 56, art. 12; Detailed Rules on FFFI, supra note 66, art. 15.

189. Detailed Rules on FFFI, supra note 66, art. 13.

190. See Allens Arthur Robinson, supra note 159, at 5-6.

191. See infra notes 192-95 and accompanying text.


193. See Anyuan Yuan, China’s Entry into the WTO: Impact on China’s Regulating Regime of Foreign Direct Investment, 35 INT’L LAW. 195, 217 (stating that China’s current legal system lacks transparency for several reasons. First, the laws are too generalized, and therefore leave a great deal of discretion to career bureaucrats. Second, China lacks the compilation of laws and regulations. Lastly, there are no official compilations for local rules and regulations).
"other requirements" might mean.\textsuperscript{194} It might be a good legislative practice not to specify the requirements and give the regulatory agency some flexibility. In practice, if Foreign Banks need to divert valuable resources to regulatory compliance, it will inhibit them from establishing products and services well-suited to the evolving financial needs of foreign and Chinese domestic enterprises.\textsuperscript{195}

V. CONCLUSION

The Chinese banking sector is, at least for the time being, a heavily protected industry, i.e., foreign participation is allowed with significant restrictions in both geographic operations and business scope.\textsuperscript{196} The restrictions on foreign participation in the banking sector will be ultimately lifted by December 11, 2006.\textsuperscript{197} Even after 2006, however, the road to building a truly level playing field in the banking sector might still be difficult.\textsuperscript{198} Thus, currently, and very likely beyond 2006, acquiring equity stakes in Chinese domestic banks and establishing Foreign Bank Branches might be the two primary forms that Foreign Banks will find most effective in entering the Chinese banking sector.\textsuperscript{199}

Acquiring stakes in Chinese domestic banks brings many benefits to foreign financial investors.\textsuperscript{200} It permits them to indirectly engage in banking businesses that are currently open only to Chinese domestic banks, such as dealing in RMB business with Chinese individuals.\textsuperscript{201} It also allows them to indirectly acquire an existing

\textsuperscript{194}. See Regulations on FFFI, supra note 56, art. 20(3).
\textsuperscript{195}. See Yuan, supra note 193, at 217.
\textsuperscript{196}. See supra notes 176-81 and accompanying text.
\textsuperscript{197}. See Table II, supra p.106.
\textsuperscript{198}. See Freshfields Bruckhaus Deringer, Acquiring Strategic Stakes in PRC banks, August 2003, at 2-3, available at http://www.freshfields.com/practice/corporate/publications/pdfs/6219.pdf. (stating that stiff regulatory barriers to entry such as high working capital requirements, the separate calculation of capital adequacy ratio for different branches as to RMB loans might delay the creation of a truly level playing field) (last visited Feb. 12, 2005).
\textsuperscript{200}. The Honorable John McCallum, Speech to the Canada China Business Council (Mar. 28, 2002), available at http://www.fin.gc.ca/news02/02-026_1e.html (noting that acquiring equity stakes in Chinese domestic banks will provide a win-win situation for all parties involved).
\textsuperscript{201}. See Freshfields Bruckhaus Deringer, supra note 198, at 3.
branch network. Because the non-state owned commercial banks (joint stock commercial banks and city/urban commercial banks) are perceived to have lower non-performing loan ratios and healthier balance sheets than the Big Four, the acquisition of stakes in these banks is likely to produce higher return on investment than acquisition of shares in the Big Four.

In addition, establishing Foreign Bank Branches might be another commercially favorable way to enter China’s banking sector. After the cancellation of the one-year waiting period restriction, foreign banks can now establish as many branches as they see fit. In addition, Foreign Bank Branches have lower capital requirements than Wholly Foreign-Owned Banks and Joint Venture Banks and still can engage in the same business activities as Wholly Foreign-Owned Banks and Joint Venture Banks. Finally, just as Wholly Foreign-Owned Banks and Joint Venture Bank, Foreign Bank Branches enjoy the supernational tax treatment, which is obviously advantageous.

Despite the present difficulties facing Foreign Banks and the Chinese banking sector’s inherent weaknesses, a balanced review of evidence suggests that leading foreign financial institutions will continue to make China a major target for their future growth. Acquiring equity stakes in Chinese Joint-Stock Commercial Banks and establishing Foreign Bank Branches are likely to put the Foreign Banks in a favorable position to navigate the unfolding dynamics of the Chinese financial system.

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202. Id.
204. See infra notes 204-207 and accompanying text.
205. See supra notes 155-56 and accompanying text.
206. See supra notes 60, 68, 76 and accompanying text.
207. See supra note 138 and accompanying text.
208. See David Boraks et al., Cap Crusader, AM. BANKER, Dec. 10, 2004, at 2 (quoting Bank of America CEO’s view that BofA’s future expansion could include a move into China).
209. See supra notes 200-204 and accompanying text.