Paul, Weiss, Rifkind, Wharton & Garrison

China's New Regulations on Foreign-Invested Financial Institutions

Lester Ross

Foreign banks and finance companies have established a modest presence in the People's Republic of China ("China"). As of year end 2001, foreign banks had established 190 business organizations, including 158 branches of foreign banks with total assets of USD45.2 Billion, in addition to 214 representative offices which are not permitted to engage in business. Penetration of the China market has been impeded by unclear and non-prudential restrictions on the establishment of a presence in China and regulatory limitations on the kinds of businesses in which they may engage and the types of customers whom they may serve.

China committed to gradually open its banking and finance markets to foreign investors as a condition to its WTO accession, including the elimination of non-prudential restrictions and the relaxation of controls on the conduct of Renminbi business and to Chinese customers. Revised regulations issued in December 2001 and January 2002 reflect China's commitments in this regard but include several provisions which promise to slow the geographic and business expansion of foreign and foreign-invested banks and finance companies in China.

<u>The Regulations and WTO</u>

The State Council approved the Regulations of the People's Republic of China on the Administration of Foreign-Invested Financial Institutions (the "Regulations") on December 12, 2001, with effect from February 1, 2002. The Regulations replace the 1994 document of the same name (the "1994 Regulations"). The Regulations were needed to implement the banking services component of China's WTO accession obligations, but also incorporate several other changes. Less than two months later, the Implementing Regulations for the Regulations of the PRC on the Administration of Foreign-Invested Financial Institutions (the "Implementing Regulations") were promulgated on January 29, 2002, also with effect from February 1, 2002. The Implementing Regulations replaced five sets of regulations governing foreign-invested financial institutions.[1]

---

[1] Implementing Regulations for the Regulations of the PRC on the Administration of Foreign-Invested Financial Institutions (April 30, 1996), Provisional Measures on the Establishment of Branch Organizations by Foreign Banks in China (January 4, 1996), Provisional Administrative Measures on the Trial Administration of Renminbi Business by Foreign-Invested Financial Institutions in Shanghai Pudong (December 2, 1996), Provisional Regulations on the Duties and Qualifications of Middle and Senior Management Personnel of Foreign-Invested Financial Institutions (May 15, 1997) and Guidelines on the Closure of Branch Business Organizations in China by Foreign Banks (April 21, 1999). Implementing Regulations, Article 113.

Like the 1994 Regulations, the Regulations apply to foreign-invested banks and finance companies in the PRC which are regulated by the People's Bank of China ("PBOC"). Foreign-invested banks may be established as wholly foreign-owned banks, branches of foreign banks, or Chinese-foreign equity joint venture banks with 25% minimum foreign investment. Foreign-invested finance companies may be established as wholly foreign-owned finance companies or Chinese-foreign equity joint venture finance companies with 25% minimum foreign investment. Thus, the Regulations do not apply to the increasing number of financial institutions, such as Bank of Shanghai and Nanjing City Commercial Bank, organized as companies limited by shares with foreign ownership below the 25% joint venture threshold. Nor do the Regulations apply to foreign investment in other types of financial institutions, such as insurance companies, fund management companies and securities companies, which are governed by separate regulations and subject to supervision by different regulatory bodies.[2]

China's WTO commitments with respect to banking were the elimination upon accession of geographic restrictions on foreign currency business and a progressive removal of geographic restrictions on Renminbi business within five years after accession. Engagement in Renminbi businesses had already been permitted on a selective basis in Shanghai and Shenzhen. Under China's WTO Schedule of Specific Commitments on Services (the "Schedule"), foreign-invested financial institutions are eligible to participate in Renminbi business if (i) they have engaged in business operations in China for three years and (ii) such operations have been profitable for two consecutive years prior to the application. These conditions are reflected in Article 20 of the Regulations, as discussed below. In addition to geographic restrictions, all non-geographic restrictions with respect to type of customer, i.e., Chinese-invested enterprises and Chinese natural persons, with respect to foreign currency business are removed upon accession, and progressively over five years with respect to Renminbi business.

Scope of Business

The distinction between banks and finance companies is a function of the businesses in which, subject to PBOC approval, they are permitted to engage.

Banking services are defined in the Schedule as:

a. Acceptance of deposits and other repayable funds from the public;

b. Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction;

---

[2] Administrative Regulations on Foreign-Invested Insurance Companies (adopted by the State Council on December 5, 2001 and effective February 1, 2002). Regulations on Chinese-foreign joint venture fund management companies and securities companies are expected to be promulgated by the China Securities Regulation Comission.

c. Financial leasing;

d. All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts (including import and export settlement);

e. Guarantees and commitments;

f. Trading for own account or for account of customers; foreign exchange.

All of the above with the exception of financial leasing are authorized under Articles 17-18 of the Regulations. Regulatory authority with respect to financial leasing in the Regulations was excluded from the scope of banking services because the PRC has previously established that financial leasing must be conducted through financial leasing companies, rather than banks. Financial leasing companies are governed by the Administrative Measures on Financial Leasing Companies (2000) and, with respect to foreign-invested financial leasing companies, the Tentative Measures on Administration of the Examination and Approval of Foreign-Invested Leasing Companies (2001). Thus, administrative authority over the establishment of foreign-invested financial leasing companies rests with the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") rather than the PBOC, although the PBOC is the primary regulator of the operations of financial leasing companies as well as of banks and finance companies.

Article 17 specifically provides that foreign-invested banks may engage in the following businesses subject to approval:

(1) acceptance of deposits from the public;

(2) making short-, medium- and long-term loans;

(3) handling note acceptances and discounts;

(4) trading in government and financial bonds and trading in foreign exchange-denominated securities[3] other than stock;

(5) provision of L/C services and guarantees;

(6) handling of domestic and foreign settlements;

(7) trading in foreign exchange on its own account and as agent;

(8) engaging in foreign currency exchange;

(9) engaging in interbank lending and borrowing;

---

[3] Bonds issued offshore by Chinese or foreign governments, Chinese financial institutions and other Chinese institutions under Article 29 of the Implementing Regulations.

(10) engaging in bank card business;

(11) provision of safe deposit box services;

(12) provision of banking business-related credit investigation and consultancy services;[4] and

(13) other businesses with approval of the PBOC.

Foreign-invested finance companies under Article 18 are eligible to engage in a more limited range of businesses:

(1) acceptance of time deposits in minimum amounts of CNY1,000,000 or the equivalent in freely convertible funds with a minimum term of 3 months;

(2) making short-, medium- and long-term loans;

(3) handling note acceptances and discounts;

(4) trading in government and financial bonds and trading in foreign exchange-denominated securities[5] other than stock;

(5) provision of guarantees;

(6) trading in foreign exchange on its own account and as agent;

(7) engaging in interbank lending and borrowing;

(8) provision of banking business-related credit investigation and consultancy services;[6]

(9) provision of foreign exchange trust services; and

(10) other businesses with approval of the PBOC.

Other than authorization to engage in Renminbi businesses subject to the progressively relaxed Licensing Procedures restrictions noted above, the Regulations largely correspond to the 1994 Regulations with respect to the businesses in which foreign-invested financial institutions may engage.

---

[4] Detailed in Article 30 of the Implementing Regulations.

[5] Bonds issued offshore by Chinese or foreign governments, Chinese financial institutions and other Chinese institutions under Article 29 of the Implementing Regulations.

[6] Detailed in Article 30 of the Implementing Regulations.

Licensing Procedures

Foreign banks and governments strenuously objected to China's pre-WTO practice of issuing licenses in very small numbers, based in part on diplomatic and other factors rather than prudential criteria or the safety and soundness of the applicant. The Schedule provides that the:

> Criteria for authorization to deal in China's financial services sector are solely prudential (i.e., contain no economic needs test or quantitative limits on licenses). Within five years after accession, any existing non-prudential measures restricting ownership, operation, and juridical form of foreign financial institutions, including on internal branching and licenses, shall be eliminated.

The Schedule further provides the financial preconditions for the establishment of a foreign-invested bank or finance company:

type of financial institution	minimum total assets
wholly-owned bank or finance company	USD 10 Billion
branch of foreign bank	USD 20 Billion
joint venture bank or finance company	USD 10 Billion

These financial preconditions are identical to the Former Regulations and are reflected in Articles 6-10 of the Regulations without change. They do not constitute substantial barriers to market entry for global financial institutions likely to expand into China, although they will impede the entry of smaller regional institutions. However, a foreign financial institution must have established and maintained a representative office in China for at least two years to establish a wholly foreign-owned bank, branch bank or wholly foreign-owned finance company, or have established and maintained such an office, albeit without the seasoning requirement, to establish a joint venture bank or joint venture finance company. Wholly foreign-owned banks under Article 4 of the Implementing Regulations can be established only if the shareholders are entirely or predominantly commercial banks, and similarly wholly foreign-owned finance companies can be established only if the shareholders are entirely or predominantly commercial banks or finance companies. The foreign investors in joint venture banks and joint venture finance companies similarly must be exclusively or predominantly commercial banks in the case of banks or exclusively or predominantly commercial banks or finance companies in the case of finance companies under Article 5 of the Implementing Regulations. Commercial banks investing in such financial institutions must have 8% minimum capital adequacy ratios.

China also committed as a condition to its WTO accession that upon accession its "licensing procedures and conditions would not act as barriers to market access and would not be more trade restrictive than necessary". Specifically it would ensure that:

(a) China's licensing procedures and conditions were published prior to becoming effective;

(b) In that publication, China would specify reasonable time frames for review and decision by all relevant authorities in China's licensing procedures and conditions;

(c) Applicants would be able to request licensing without individual invitation;

(d) Any fees charged, which were not deemed to include fees determined through auction or a tendering process, would be commensurate with the administrative cost of processing an application;

(e) The competent authorities of China would, after receipt of an application, inform the applicant whether the application was considered complete under China's domestic laws and regulations and in the case of incomplete applications, identify the additional information that was required to complete the application and provide the opportunity to cure deficiencies;

(f) Decisions would be taken promptly on all applications;

(g) If an application was terminated or denied, the applicant would be informed in writing and without delay the reasons for such action. The applicant would have the possibility of resubmitting, at its discretion, a new application that addressed the reasons for termination or denial;

(h) If an application was approved, the applicant would be informed in writing and without delay. The license or approval would enable the applicant to start the commercial operations upon registration of the company with SAIC [State Administration for Industry and Commerce] for fiscal and other similar administrative purposes. The registration would be completed within 2 months of the submission of a complete file, as required by public SAIC regulations, and in accordance with China's Schedule of Specific Commitments [on Services].

The Regulations reflect China's commitments with respect to licensing. Under Article 13 the PBOC has 6 months (up to 9 months when necessary) to conduct a preliminary examination of any application. If the examination is favorable, the application is deemed "accepted" and only then is an application form presented to the applicant for completion. The applicant under Article 14 of the Regulations and Article 19 of the Implementing Regulations then has up to 6 months (9 months with PBOC approval) to complete and submit the application. Under Article 15 of the Regulations and Article 25 of the Implementing Regulations the PBOC then has an additional 2 months to decide whether to approve or reject the application. If approved, the applicant under Article 16 submits the PBOC approval document to the

SAIC for registration which, under China's WTO commitments, must be completed within 2 months. If rejected the applicant must wait a year before applying to establish a business organization in the same city under Article 25 of the Implementing Regulations. Additional details with respect to applications (including applications for additional time) are provided in Chapter 2 of the Implementing Regulations.

Although the amount of time required to obtain an approval generally ought to be less than the maximum allowed under the Regulations, the Regulations and Implementing Regulations allow the PBOC to use the procedures to delay the expansion of foreign-invested financial institutions. For example, the approval procedure could be simplified if the application form was provided to the applicant at the outset, eliminating the necessity for a two-stage approval procedure. Branching, like reapplication in the event that an application is rejected, is impeded by a substantial waiting period. Foreign-invested financial institutions must wait one year after a branch application's approval date before submitting an application to establish an additional branch under Article 14 of the Implementing Regulations ostensibly to enable the PBC to determine whether a major violation of regulations has been committed by the existing branch(es). Article 15(4) of the Implementing Regulations further requires that a foreign-invested bank applicant allocate the equivalent of at least CNY 100 million in freely available funds as the new branch's operating funds, and that the applicant's nationwide total operating funds may not exceed 60% of its registered capital. This latter requirement is identical to that for domestic banks under Article 19 of the Commercial Bank Law (1995).

Articles 33-36 of the Implementing Regulations, as authorized under Articles 19-20 of the Regulations, impose additional funding requirements (in addition to the seasoning and profitability requirements provided in the Schedule) on foreign-invested financial institutions applying to engage in Renminbi business and business with respect to Chinese, non-foreign-invested enterprise customers. The funding requirements for wholly foreign-owned banks and joint venture banks are not terribly different from those that apply to Chinese-invested banks (CNY1 Billion for commercial banks under Article 13 of the Commercial Bank Law), but the separate funding requirements for foreign bank branches (the most likely vehicle to penetrate China's market at this time) are particularly onerous and institute additional barriers to expansion.

Funding Amount (CNY Million)			
	Foreign Bank Branches (operating funds)	Wholly Foreign-Owned and Joint Venture Banks (registered capital)	Wholly Foreign-Owned and Joint Venture Finance Companies (registered capital)
Forex business with all foreign and foreign-invested customers and some forex business	100	300	200

with other enterprise customers			
Forex business with all customers	200	400	300
Forex business with all foreign and foreign-invested customers, Renminbi business with foreign-invested customers, some foreign exchange and some Renminbi business with other enterprise customers	200 (100 Renminbi, 100 forex)	400 (100 Renminbi, 300 forex)	300 (100 Renminbi, 200 forex)
Forex business with all customers, Renminbi business with foreign-invested customers and some Renminbi business with other enterprise customers	300 (100 Renminbi, 200 forex)	500 (100 Renminbi, 400 forex)	400 (100 Renminbi, 300 forex)
Forex business with all customers, Renminbi business with foreign-invested and other customers	400 (200 Renminbi, 200 forex)	600 (200 Renminbi, 400 forex)	500 (200 Renminbi, 300 forex)
Forex and Renminbi business with all customers	600 (400 Renminbi, 200 forex)	1,000 (600 Renminbi, 400 forex)	700 (400 Renminbi, 300 forex)

Article 37 of the Implementing Regulations defines "some" foreign exchange business as foreign exchange deposits, export settlements, loan-related import settlements and inward remittances, while "some" Renminbi business refers to Renminbi loans and their underlying revolving deposits and guarantees by non-foreign-invested enterprises for loans issued by such foreign-invested financial institution.

Chapter 4 of the Regulations provides that foreign-invested financial institutions are subject to supervision by the PBOC with respect to deposits, interest rates on loans and fees (Article 22); mandatory reserve deposits with the PBOC (Article 23); placement of at least 30% of working capital of a foreign bank branch in PBOC-designated interest-bearing deposits such as bank deposits (Article 24); maintain an 8% minimum capital adequacy ratio (Article 25); single borrower credit limit of 25% of capital unless a larger percentage is approved by the PBOC (Article

26); fixed assets not to exceed 40% of equity (Article 27); a ratio of Renminbi capital to Renminbi risk assets of at least 8% (Article 28); a ratio of liquid assets to liquid liabilities of at least 25% (Article 29); domestic foreign currency deposits generated within China may not exceed 70% of their total foreign currency assets within China, (Article 30); and maintenance of reserves against bad and doubtful loans (Article 31).

Conclusion

The Regulations and Implementing Regulations address other subjects, especially the qualifications of management personnel, dissolution and penalties for violations. However, for most foreign investors, the immediate concerns are establishment and expansion. The Regulations and Implementing Regulations provide extensive guidance on how foreign-invested financial institutions will be subject to examination and approval and then supervision by the PBOC. These procedures are WTO-compatible so long as the stringency of supervision of foreign-invested financial institutions does not contravene China's WTO accession commitments or other WTO obligations. Although it appears that China under the new regulatory authority will be in compliance with its WTO commitments, expansion in China is likely to be significantly impeded by mandatory waiting periods and high funding requirements with respect to the establishment of additional branches.