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# Foreign bank regulation revised to fully open-up banking sector

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In accordance with its commitments upon the entry into WTO, China should phase out all the geographical and cliental restrictions on foreign banking service providers by the end of 2006[1]. The newly revised foreign bank regulation[2] and its implementing rules[3] (hereinafter collectively referred to as the "**New Foreign Bank Rules**"), which have replaced their previous version promulgated at the onset of WTO entry five years ago, are the milestone set for a fully opened-up banking sector for foreign service providers.

This issue of **CHINA***journal* purports to give a brief review on the New Foreign Bank Rules and their impacts on foreign banks' operation in China. It shows that in order to fully exploit the market opportunity promised by the new rules, foreign banks would have no other choice but to incorporate legal-person entities or convert their standing branches into subsidiaries. Recent agency measures have been issued to address the foreign exchange and tax related matters associated with such process of branch-to-subsidiary conversion.

## A level playing field for both foreign and domestic banks

The New Foreign Bank Rules reflect China's efforts to level the playing field for both foreign and domestic banks in the light of WTO's fundamental national treatment principle. The former preferential or discriminatory treatment is neutralized towards an equal term. To the disadvantage of the foreign funded bank, the initial capital is now substantially increased from what was requested, so as to bring the level equivalent to that of the Chinese banks. As such, the initial capital requirement for a WFOE or JV banks is increased to RMB 1 billion (from RMB 30 million), equivalent to what is required for Chinese domestic banks. The minimum operational fund for a branch of a WOFE or JV bank is set to RMB 100 million and should not exceed 60% of the own capital of the bank. All these thresholds are aligned with those applicable to the domestic banks.

On the other hand, foreign funded banks are given green light to an expanded business scope. The geographic and cliental coverage of their services are potentially extended to the entire country and the whole population. Foreign funded banks

[1] Part II – Schedule of Specific Commitments on Services List of Article II MFN Exemptions annexed to the Protocol (WTO, Ministerial Conference Fourth Session, Doha, 9-13 November, WT/MIN(01)3/add.2, 10 November 2001.)

[2] The Regulation on Administration of Foreign-funded Bank, promulgated by the State Council on November 11, 2006 and effective as of December 11, 2006.

[3] The Implementing Rules of the Regulation on Administration of Foreign-funded Bank, promulgated by the China Banking Regulatory Committee (CBRC) on November 24, 2006 and effective as of December 11, 2006.

are for the first time permitted to tap in the lucrative RMB retail business unfettered with the Chinese individuals as their mass customer base. Up till the New Foreign Bank Rules, they were only allowed to serve this market in a limited number of designated cities, subject to tedious approval procedures. It is therefore fair to say that foreign funded banks are placed at equal footing with their Chinese rivals in terms of permitted scope of business operation.

Besides, prudential regulation regarding internal control, information disclosure and corporate governance have been particularized, in a compatible form of those applicable to Chinese domestic banks, which reflects a shift of regulatory focus from the market entry/access to the ongoing prudential monitoring.

Above all these, the recently revised company income tax law[4] has unified the tax regime for domestic and foreign banks so that they are subject to a uniformed corporate tax.

## Subsidiaries in priority to branches

A proviso has been placed in the New Foreign Bank Rules regarding the RMB retail business. It is provided that local branches of foreign banks could conduct retail RMB business with Chinese individual customers only in fixed deposit terms with each transaction of no less than RMB 1 million, i.e. limited to those extremely affluent customers. This restriction keeps a large portion of the population out of the reach of foreign banks' local branches.

In order to fully exploit the RMB retail business, a WFOE or JV bank thus has to be incorporated from scratch or converted from a standing branch. Notably, this would involved a larger capital commitment, considering a WFOE or JV bank requests a minimal capital of RMB 1 billion and a branch requests, even though having been increased by the New Foreign Bank Rules, only a minimal operational fund of RMB 200 million. Such high capitalization requirement and its obstructive impact on the business development for foreign banks' operation have been complained as inconsistent with WTO law and Chinese commitment upon its entry. However, China grounds these rules on the basis of financial system security and prudential supervision and deems these fully compatible with WTO rule.

Therefore, for those foreign banks with a vision of serving the mass population of Chinese individuals, it is indispensable to incorporate a WFOE or JV bank in China. Alternatively, it can also convert a standing branch into a WFOE bank or into a branch of a WFOE bank based upon prescribed rules and procedures.

## Matters related to the conversion from a branch to a WFOE bank

To facilitate the process of converting a foreign bank's branch into a WFOE bank (or its branch), various agencies have promulgated guiding rules regarding the tax and foreign exchange issues that are associated with the conversion[5]. Accordingly, a general tax exemption is granted with regard to gross revenue and income (in case of transferring assets at book value) that are generated in the course of conversion. Accumulated loss or outstanding tax breaks that the branch possesses could be inherited by the WFOE bank after the conversion. Also, those qualifications that authorize the branch to engage in various forms of foreign exchange transaction (spots, forwards or derivatives) or QFII depository service could be retained by the WFOE bank. The position of retainable forex quota of the branch could also be inherited. All these guidelines appear to limit the transaction costs related to the conversion to the minimum.

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[4] The PRC Enterprise Income Tax Law, adopted by the National People's Congress on March 16, 2007 and effective as of January 1, 2008.

[5] Circular on Several Tax Issues in Relation to the Conversion of a Foreign Bank Branch into a WFOE Bank (Cai Shui [2007] No. 45), promulgated jointly by the Ministry of Finance and the State Tax Administration on March 26, 2007 and effective as of the same date; Circular on Several Foreign Exchange Issues in Relation to the Conversion of a Foreign Bank Branch into a WOFE Bank (Hui Fa [2007] No. 15), promulgate by the State Administration of Foreign Exchange on March 20, 2007 and effective as of the same date.

## Conclusion

The New Foreign Bank Rule is the last stroke for the fulfilment of China's commitments under WTO entry in banking sector. Foreign funded banks are now placed at equal footing with domestic banks in terms of market dimension, client base, tax charges and supervisory obligations. To fully exploit the enlarged market opportunity, foreign banks are likely required to incorporate subsidiaries instead of relying on existing branches. The most recent measures of various agencies help to address the transaction cost and procedure in relation to the branch-to-subsidiary conversion and tend to limit the costs to the minimum.



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