

Instituto Superior de Ciências do Trabalho e da Empresa



**A STUDY ON SUPERVISION OVER FOREIGN BANKS IN CHINA**

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## **Abstract**

The five-year transitional period after China's entry into WTO has expired. To fulfil her promise of opening up the financial service market, China has cancelled all the restrictions on the scope of business and regional access for foreign-funded banks. Although the State Council has enacted the recently revised «Regulation of the People's Republic of China on the Administration of Foreign-funded Banks» and the «Rules for Implementing the Regulations of the People's Republic of China on Administration of Foreign-funded Banks» as the main legal document on regulating foreign-funded banks, and, as obvious, flaw is unavoidable. And we must improve the supervisory legal system of foreign-funded banks in China to dissolve the risk arising by the entry of foreign-funded banks. This research work analyses and discuss the practical impact of the current legislation for supervision of foreign-capital banks, supervision of market access of foreign-capital banks, the supervision on RMB business management in foreign capital banks and the legal system for internal control of foreign banks. In the end of the dissertation, the improvement towards the perfection supervision of the foreign banks in PRC will be emphasized with respect to the new opening situation.

Key words:

Supervisory legal system of foreign-funded banks; Market Access of Foreign-capital Banks; RMB Business Management; Internal control of foreign banks

JEL Classification: E44 G18

## **Resumo**

O período de transição concedido à República Popular da China (RPC) na sua admissão na Organização Mundial do Comércio (OMC) já caducara. Segundo os compromissos de admissão na OMC, o sector financeiro da China passou a estar completamente aberto no final de 2006, e são abolidas todas as restrições para os bancos de capital estrangeiro no que respeita ao tipo de operações bancárias e no que respeita à extensão geográfica de operação. O Conselho de Estado promulgou a lei denominada de “Os Estatutos de Administração dos Bancos de Capital Estrangeiro” e ainda o decreto-lei de “Regulamentação para a implementação dos Estatutos de Administração de Bancos de Capital Estrangeiro” e estes constituem os principais documentos jurídicos que servem de base para uma efectiva administração e supervisão dos bancos de capital estrangeiro. Subsistem, no entanto, muitos aspectos por melhorar, sobretudo no que respeita aos limites e abertura do sistema. O presente trabalho cinge ao estudo e análise de como melhorar a supervisão dos bancos de capital estrangeiro, através da análise de vários discursos de dirigentes do Estado, da análise do estado actual da legislação de administração e supervisão dos bancos de capital estrangeiro, do sistema de leis de administração e supervisão no acesso ao mercado financeiro, de operação de RMB e do sistema legal de supervisão e controle interno das empresas. Discutiremos no final do trabalho as ineficiências do sistema legal de administração e supervisão dos bancos de capital estrangeiro da China, com base na realidade de que os bancos de capital estrangeiro entraram na China para explorar o mercado financeiro nacional. Proporemos sugestões e recomendações com vista a melhoria do sistema legal de administração e supervisão dos bancos de capital estrangeiro na China.

Palavras chave:

Supervisão de bancos de capital estrangeiro; RMB

Acesso ao mercado de capitais; controlo interno.



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## 1. INTRODUCTION

### ***1.1. Research Background***

China has begun to admit operations in its own land foreign banks since 1979. After 20 years of this experience, China has officially joined WTO on December 11, 2001. Therefore, it has been inevitable to further open up the financial market. The People's Bank of China also promised on December 9, 2001 in "Announcement of the People's Bank of China on Relevant Issues Concerning the Market Entry of Financial Institutions with Foreign Investment" to gradually open up the banking sector after China's WTO entry. To this end, China amended the "Regulations of the People's Republic of China Governing Financial Institutions with Foreign Capital" on December 12, 2001. In accordance with the regulation, almost all financial business has been or will soon be open to foreign financial institutions. On April 28, 2003, China Banking Regulatory Commission was officially set up. After that, China Banking Regulatory Commission took on the foreign bank supervision right as formerly exercised by the People's Bank of China. On December 27, 2003, China promulgated "Law of the People's Republic of China on Regulation of and Supervision". On March 8, 2004, China Banking Regulatory Commission published "Measures for the Administration on Consolidated Financial Statements in Conducting Supervision Over Foreign-funded Banks", two laws came into effect respectively on February 1, 2004 and April 1, 2004. The release of two new laws "Regulation of the People's Republic of China on the Administration of Foreign-funded Banks" and the "Rules for Implementing the Regulations of the People's Republic of China on Administration of Foreign-funded Banks" in 2006 are not only the latest achievements of China's financial system reform, but also the important measures to adapt to the new opening situation of financial market after China's entry into the WTO; This new set of Regulations form the legal basis for the supervision system of foreign banks and will have far-reaching significance in supervision on foreign banks in China.

It can be seen that after 10 years of exploration and practice, China has established a set of prudent and comprehensive foreign bank supervision systems. But with the passing of time

and progress in financial globalization, the existing supervision system gradually revealed its unreasonable side. With the deepening of domestic reforms and the opening expansion, the Government is gradually fulfilling the commitment to further open up the domestic financial market, fully opened the domestic market to foreign banks, and lifted restrictions of region and service targets from foreign banks, allowed them to operate Renminbi retail business and fully implemented national treatment. This has given foreign banks opportunities to invest and develop in China.

### ***1.2 Purpose and objectives***

With respect to the new situation, the release of the two new laws “Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks” and “Rules for Implementing the Regulations of the People’s Republic of China on Administration of Foreign-funded Banks” in 2006 constitute the latest achievements of China's financial system reform, but it is also the step ahead in order to adapt to the new opening situation of financial market after China’s entry into WTO. The” Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks” targets to improve the supervision of market access of Foreign-capital Banks, the supervision on the RMB Business Management in Foreign Capital Banks and the legal system for internal control of foreign banks. Moreover, the regulations improve the current supervision of Foreign-capital Banks as the legal basis. However, in the long run, whether the Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks and its implementation can better solve various deep-seated problems faced by our country’s immature financial markets, about which we can not be blindly optimistic.

In my opinion, the supervision system on foreign banks also needs to be improved from other aspects like legislation, institutional system, and supervisory approach and supervision contents.

### ***1.3 Structure of the dissertation***

This dissertation focuses on an analytical view upon how to improve PRC supervisory legal system of foreign-funded banks and it is divided in five parts.

The first part of this work delimits the scope of foreign-funded banks and defines the concept of supervising foreign-funded banks firstly, and then gives a brief introduction to the core spirit of «General Agreement on Trade in service», «the Global finance service agreement» and relevant regulations concerning the banking market in WTO system while giving the outline of the agreement formulating by the Basle Committee, which is the most important institution that controls the activity of all the banks<sup>1</sup>.

The second part will mainly analyse the supervision and regulation system of foreign-funded bank's market access. After giving a brief review of the definition of supervision on foreign-capital banks' market access, it points out the current specific systematic arrangement on market access of foreign-capital banks. Then it gives the some proposals to improve the supervision system of Foreign-capital Banks' market access.

The third part discusses supervision and regulation system of foreign-funded banks' RMB Business. It indicates the supervision defects on RMB business management in foreign capital banks. And then it lists the measures to improve the supervision system on RMB business management in foreign capital banks to be perfect.

The fourth part focuses on the objectives and contents of a sound and effective internal control system of banks on the basis of the analyzing the relevant documents of the Basle Committee. Moreover, it put forwards the defects and suggestions of improvement the legal system for Internal control of foreign banks.

The fifth part is the key part of the thesis. In this part, the author lay out his view on perfecting the legal supervision system of foreign banks at present. Additionally, she gives the advices to perfect of legal supervision system of foreign banks in China.

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<sup>1</sup> Cai Yi: " Major Law Issues Research on Multi-national Bank Supervision", The Xiamen University Press, 2004 edition page 170



## 2. CHINA'S WTO COMMITMENTS AND CURRENT LEGISLATION FOR SUPERVISION OF FOREIGN-CAPITAL BANKS

### *2.1 Outline of supervision law system of foreign-capital banks*

Generally, the definition of foreign-capital banks which is named relative to Chinese local banks includes comprehensions in both narrow and general senses. The foreign-capital banks in narrow sense refers to those banks with head office in host country and all the capital from foreign investors, which equivalent to the wholly foreign owned enterprises. The foreign-capital banks in general sense include not only the said ones, but normally various forms of branches set up in host country by foreign banks, and joint venture banks established by investors from both host and foreign countries, even the representative office set up in host country by foreign banks. As currently the transnational capital flow already became a prevailing trend, every country now has to consider the actual needs for foreign capital while defining the foreign-capital banks instituted inside their countries, therefore, different countries have different meanings for foreign-funded banks. China's newly executed "PRC Regulations for the Administration of Foreign-invested Banks" stipulates foreign-invested banks<sup>2</sup> in three organizing forms, which are:

- **Representative office.** This is the simplest form of branch established in another country as foreign banks. A representative office doesn't have corporate capacity and right of business, which can only deal with the connection, communication, and information collection activities.
- **Branch.** Branches are the most common form as foreign banks doing business in another country and considered as components of the head office and extensions of the foreign banks in the host country, the head office can directly manage its branches on basis of unlimited liability. Branches don't have legal person status in the host country as foreign legal person, although almost all the banking business at home and abroad can be operated, it is hard for the

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<sup>2</sup> «Regulation of the People's Republic of China on the Administration of Foreign-funded Banks» Article 2

host country to carry out effective control for these businesses are listing in the balance sheet of the head office. From the perspective of supervisory authority of the host country, branch is the one with highest risks among all the organizing forms of foreign funded banks, but with the powerful capital support of the head office which takes the responsibility of salvage such as lender of last resort together with home country, they can provide stronger protection to the depositors in host country.

● **Sub-bank.** This refers to the economic entities registered in the host country with legal personality and independent from the head office. Sub-bank can be not only wholly owned by the head office, but also can set up by joint venture under the management of the head office. As far as the home country concerned, the head office don't have to undertake any operation risk, but only has the limited liability based on its investment amount, the sub-banks are strictly controlled under the relative law of the host country. As the legal person in host country, the sub-bank of foreign bank is under the complete intendance of the financial supervision authorities which has to take the business risks at the same time. At present, there are two forms of sub-bank in China, (wholly foreign-funded banks by sole capital contribution of a foreign bank or by joint investment of a foreign bank and other foreign financial institution) and “ Chinese-foreign joint-equity banks established by the joint capital of foreign financial institutions and Chinese corporations and enterprises” .

The supervision of foreign-capital banks means the intendance and management to this kind of banks, and the legal system of the supervision of the foreign-funded banks is the general name of legal norms and relevant systems for adjusting the regulation relationship of foreign-capital banks.<sup>3</sup> In this work, foreign-capital bank supervision refers to the regulation and restriction of banking supervision authorities conducted to the organization and businesses of foreign-capital banks according to the relative laws and norms of banking industry. The foreign banks entered with both advantages and disadvantages for China's financial market. In term of benefits, the introduction of foreign banks created a new phase for China's utilization of foreign capital, and opened up a new way for the foreign capital

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<sup>3</sup> Yan Qingming: "Research on China Banking sector Supervision", The China Financial Press, 2002 edition

absorption and utilization, compensated the insufficient domestic construction fund, and promoted the foreign direct investment in our country to a certain extent; and meanwhile, advanced financial management technique has been introduced to provide relatively perfect foreign-related financial service and international market information for foreign-funded, import and export enterprises in our country, as well as the favorable conditions for domestic financial institutions to learn advanced foreign management experience and cultivate modern financial management talents, strengthened the competition mechanism of China's financial industry, and greatly promoted the reform of financial system as well as contributed to the overall improvement of operation and management level and even the internationalization of China's financial industry. The disadvantages are also very obvious. As the foreign banks set foot in financial industry which is the core of our national economy, any of their actions may effect our integrated economic operation, especially under the present circumstances of imperfect financial system reform and relatively lower development level of financial industry as well as the unsound market system. Usually, the foreign-capital banks, particularly the businesses of their branches, attach great importance to the maximum profit, this means there are potential disagreement between their operating policies and China's financial policies of which the implementation will be surely influenced consequently. However, from the view of financial supervision authorities, the branches have the least intendance from the host country and considered as the most risky form for foreign-capital introduction, but they have accounted for a considerable proportion of the total number of foreign-capital banking institutions in our country. The accession of foreign capital banks enhances the effect of fluctuation transmission mechanism of international financial market, thus interfering with the regulative process of domestic currency policy and influences the stable development and structural regulation of national economy. Without appropriate management, they may have the chances to transfer the foreign exchange fund and profits overseas through legal or illegal means as the increase of foreign-capital banks and expansion of their businesses, which would go against China's financial revenue and balance of international payment. The foreign-capital banks institutions constantly enlarge their market shares and contest businesses with domestic banks on basis of their abundant capital foundation, developed information and communication network, flexible means of management as well as novel and

effective financial products. On the other hand, the foreign-capital banks institutions attract elites from China's banking industry with great pay, high welfare and favourable working conditions, resulting in brain drain of domestic banking circle. Thus, the supervision to foreign-capital banks became a crucial measure to guarantee a fair, orderly and reasonable environment for internal and foreign banks in the keen competition.

To sum up, foreign-capital banks is necessarily introduced to give service to the developing of an integrated financial industry and soaring of economic, and as a line of business with high risk, the banking industry, in particular the foreign-capital banks with the unique advantage with surely bring enormous challenge to our internal financial market. But there are still many deficiencies that mainly reflected in market access, supervisory patterns, content and forms in term of regulation on foreign-funded banks, such as the low legislative level and effective grade of the related laws, and lack of authority of law; the unclear supervisory object of the prudent laws and regulations, insufficient risk supervision and imperfect access restrictions. Therefore, it is an urgency to strengthen and perfect China's supervisory system for foreign-capital banks.

## ***2.2 The major requirements of WTO to banking industry and China's specific WTO commitments***

The Jurisdiction and restriction of WTO to banking industry manifest mainly in the package agreement of Uruguay Round Negotiation and the following documents such as the Financial Service Agreement. The former is a framework agreement involved the general regulations of financial service trade, for example, the definition of financial service, ways of supply and classification, national treatment, market access, MFN treatment, transparency, gradual liberalization, etc. and the latter substantially refers to the specific commitment<sup>4</sup> made after the negotiation centered the financial service area under the reached frame agreement. See Table 1 for the rule system of financial service trade under the framework of WTO.

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<sup>4</sup> Question Answering on WTO and the Opening up of China's Banking Industry Chapter3 Opening Up to the Outside World

Table 1 : Rule System of Financial Service Trade under the Framework of WTO<sup>5</sup>

<p>1 Package agreement of Uruguay Round Negotiation(09/1986-04/1994)</p>	<p>General Agreement on Trade in Service</p>	<p><u>Clauses in text of GATS</u> , 6 parts with total 32 clauses are included , the 6 parts include : jurisdiction, General Obligations and Disciplines, Specific Commitment, Gradual Liberalization, Institutional Provisions and final Provisions.</p> <p><u>Annex on Financial Services of GATS</u> , stipulates material content of the scope and definition of financial service, domestic laws and regulations of relevant financial service(including prudential carve-out), approval and dispute settlement, etc.</p> <p><u>Second Annex of GATS on Financial Services</u> is the technical regulation of transition character not involving the general behaviour rules.</p> <p>Understanding on Commitments in Financial Services, is the general regulation exclusively applicable to financial service trade and agreed and accepted by all parties participating the negotiation of financial service trade, provides more ways for the made of specific commitments to the participants.</p>
<p>2 Agreements reached after Uruguay Round Negotiation</p>		<p><u>Second Protocol of GATS</u> in 1995 , improved the commitment concerning financial service area, but due to the limited participating parties and commitment level, it is regarded as “ temporary” agreement.</p> <p>The Financial Service Agreement encompasses The Fifth Protocol approved in November of 1997 and taken effect from March 1<sup>st</sup> of 1999 and its annex. This Protocol only stipulates the issues on procedures, such as date of effectiveness, the two parts of schedule of financial service and MFN exception list comprising its annex are the main content of the Financial Service Agreement.</p>

<sup>5</sup> Id.

China officially became a member of WTO on December 11<sup>th</sup> of 2001, the country made its specific commitment in term of banking industry:<sup>6</sup>

1. Expanding the scope of foreign exchange businesses of foreign banks

After the accession, the country will lift the limitation to customers in the foreign exchange businesses of foreign banks. Foreign-capital banks can immediately provide overall foreign exchange services to Chinese enterprises and residents without the approval on case-by-case basis. And the foreign-capital banks will be immediately permitted to add businesses such as foreign currency exchange, inter-bank loan, issue of the credit card of foreign currency and foreign credit card on basis of the existing business scope.

2. Gradually expanding the scope of RMB business in foreign banks

China will expand the scope of RMB business in foreign-capital banks in various aspects after entering WTO according to the commitment. First, the foreign capital banks will be allowed to append business of bill discount, acting receipt and payment of funds and bank deposit boxes on basis of the current businesses. Second, to phase out the geographical restrictions for foreign-funded capital of those which are doing RMB businesses. Bans in Shenzhen, Shanghai, Tianjin, Dalian will be lifted after entering; and for Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan, it will be cancelled in one year after accession; for Jinan, Fuzhou, Chengdu, Chongqing in two years after accession; and for Kunming, Beijing, Xiamen within the third year; and Shantou, Ningbo, Shenyang and Xi'an within the fourth year; the restrictions in all cities will be over with the fifth year after accession. Third, relaxing the restrictions to the cross regional businesses. A foreign capital bank which is approved to operating RMB businesses in a certain city will be also allowed to provide services to the costumers from another RMB-business permitted city. Fourth, to gradually lift the restrictions to RMB business costumers. The foreign banks will be allowed to provide RMB banking to Chinese enterprises in 2 years after China's entering WTO, and

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<sup>6</sup> The Challenge in Foreign Bank Supervision after China's Accession to WTO , Northern Economy and Trade, By Zhang Long,2002 Vol. 22,P23

allowed to give service to all the Chinese costumers in 5 years after accession, which means the foreign-funded banks will be entitled to the national treatment in 5 years after China's accession.<sup>7</sup>

3. The examination and approval of sub-branches in the same city

The approval conditions for foreign banks to set up sub-branches in the same city in the same way as that for Chinese banks.

4. Issuing business license adhering to the principle of prudence

China financial supervisory departments issue the business license sticking to the principle of prudence, which means there is no economic needs test and quantitative restriction in term of the operative license. All the existing ownership, operating and establishing forms, including non-prudent measures for the control to branch institutions and the issue of license will be cancelled within China's entering WTO for five years.

### ***2.3 The status and deficiencies of China's legal system for foreign bank supervision***

Basel Committee is currently the most important institution for bank regulation in all countries of the world. Numerous documents concerning bank regulation problems has been formulated and issued by Basel Committee since its establishment, and from which the “Basel Framework” has been formed. The Basel Core Principles is the first international adaptable document from Basel Committee to the whole world, especially to the emerging market economy countries, it is also a Basel document that discussed and formed through the official cooperation of Chinese bank supervisory authorities and Basel Committee. However, as the reform of financial system and financial supervision has been long implemented the thoughts of “Double-track system” in our country, the issues on the regulation of foreign-funded banks haven't been specifically reflected in the basic supervisory laws, such as Law of the People's Bank of China and Law of Commercial Banks, but standardized in form of the administrative laws and regulations promulgated by State Council and ministries and commissions.

At present, China has basically set up a legal supervisory system for foreign-capital banks

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<sup>7</sup> The Challenge in Foreign Bank Supervision after China's Accession to WTO , Northern Economy and Trade, By Zhang Long,2002 Vol. 22,P23

including from examination and approval for practice to operating regulation, the major relative laws and statutes include: PRC Banking Regulation Law, Law of the PRC on Commercial Banks, PRC Law on Administrative Licenses, PRC Regulations for the Administration of Foreign-invested Banks, Implementing Rules for the PRC Regulations for the Administration of Foreign-invested Banks, Measures on Administration of Representative Establishments in China of Foreign-funded Financial Institutions, Measures for the Administration on Consolidated Financial Statements in Conducting Supervision Over Foreign-funded Banks, Measures for the Administration of the Entrustment of Certified Accountants for the Audit of Foreign-funded Financial Institutions, Guiding Opinion on External Auditing of Foreign-funded Banks, Interim Measures for the Management of the Service Prices of Commercial Banks, Guidelines for the Risk Management by Commercial Banks for Granting Credit to Customer Groups, Interim Measures for the Management of the Dealings of Derivative Products of Financial Institutions, Rules on Capital Adequacy Ratios of Commercial Banks, The Administrative Measures for the Connected Transactions between the Commercial Banks and Their Insiders or Shareholders, Measures of Administration on E-bank Businesses, Guiding Opinions on the External Marketing of Commercial Banks, Interim Measures for the Administration of Commercial Banks' Personal Financial Management Services, The Interim Measures for the Administration of Commercial Bank's Business on Operating the Overseas Financial Management for Clients, etc, among which the PRC Regulations for the Administration of Foreign-invested Banks and Implementing Rules are presently China's major legal basis in the examination and approval as well as routine supervision to foreign-funded banks.

After over 20 years of exploration and practice, China has established a relatively perfect system for foreign-funded bank supervision, but there is still a long way to go comparing with the requirements of WTO for financial system and the financial service industry in developed country, and still many deficiencies that mainly reflected in market access, supervisory patterns, content and forms in term of regulation on foreign-funded banks, such as the low legislative level and effective grade of the related laws, and lack of authority of law; the unclear supervisory object of the prudent laws and regulations, insufficient risk supervision and imperfect access restrictions. We must narrow the distance between our legislation and

the requirements of WTO rules, otherwise, it will be difficult for China to conduct a practical intendency to foreign-funded banks, and guarantee a stable order and healthy development of financial industry. At the same time, as a member of Basel Committee, China should improve the legislation for foreign-funded bank supervision in light of their demands.



### 3. LEGAL SYSTEM FOR THE SUPERVISION OF MARKET ACCESS OF FOREIGN-CAPITAL BANKS

#### ***3.1 The definition of supervision on foreign-capital banks market access***

The market access supervision means that for the intention of maintaining the security and stability of the banking industry and by the host country, the examination and approval conducted legally to the access application of the foreign-capital banks, and the investigation or confirmation to the situations such as operating qualification and capacity of foreign-capital bank so as to determine their access into the financial market in the host country and the necessary conditions for access application and organizing forms after the access is permitted.

Most countries in the world adopted conditional market access strategy in view of their own financial capacity in term of the market access of foreign-funded banks. According to the investigation from the US Treasury,<sup>8</sup> only 13 among the 135 members of the WTO do not have significant restriction to foreign-capital banks. For example, the Canadian way of distinguishing subsidiaries from branches is “management in different ways and different classes” ; Germany has different requirements for developed and developing countries, foreign-capital banks from some developing countries must have capital adequacy ratio over 12% in the first three years after opening, and all the credit operations must be linked up with capital scale, but there are no such regulations for branches from developed countries. The UK restricts the access of major local enterprises with shares held by foreign-capital capacity. Since the relatively weak supervision to banking operation in our country, we should attach more importance to the “source”.<sup>9</sup> We can learn from the EU experiences, and make strict regulations on basis of the capital scale and business performance of the foreign capital banks to carry out effective supervision and achieve proper control on the expansion speed of foreign-capital banks. And we must use experiences from other countries as reference, and

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<sup>8</sup> He Xiaoyong: "Law Issues on Financial Supervision in the Trend of Financial Globalization ", the law Press, 2002 edition

<sup>9</sup> Yang Yong: "Law Issues Research on Financial Groups", The Beijing University Press, 2004 edition

reasonably control the quality and scale of the foreign-funded banks entering our country as well as the overall speed of access to ensure the share of domestic banks in the banking system to prevent the excessive sudden impact from foreign-capital banks and thus avoid its monopolistic management and control to domestic financial market.

As a crucial component of financial service industry, banking industry has been rapidly developed under the trend of globalization, and the domestic and international financial market will be connected through the transnational operation of banking industry, which directly influenced the overall development of national economy. From the perspective of financial supervision, the regulation over market access is the first link of the supervision work to foreign-funded banks for the financial supervision authority of the host country.<sup>10</sup> In order to maintain the security and stability of domestic banking system, the financial supervisory authority in the host country must legally examine and approve the access applications of the foreign-capital banks through inspecting and verifying the operating qualification and management capacity to keep out those foreign financial institutions with poor quality and potential problems, and harm to the interest of depositors and order of financial industry with a view of effective prevention to the risks brought about by foreign-capital banks on the stability of financial system in the host country.

There are many supervision objectives over market access of foreign-funded banks as the basic legislative direction of access regulation of the supervisory authority. China's main objectives of market access supervision of foreign-funded banks are<sup>11</sup>:

- Prevent the unqualified institutions from entering banking market<sup>12</sup>
- The supervision makes the banking institution maintain sufficient solvency margin.
- Safeguard the security of the entire banking system.
- Improve the efficiency of the banking system<sup>13</sup>.

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<sup>10</sup> Meng Yuanzhi: " Legal Issues Research on China's Foreign Capital Bank Supervision in WTO ", master's thesis in 2004 session of the Dalian Maritime University

<sup>11</sup> Li Jinze: "New law issues in Banking reform ", The China Financial Press, 2004 edition. Page 4

<sup>12</sup> Same as above,

<sup>13</sup> Same as above, Page 5

### ***3.2 The current specific systematic arrangement on market access of foreign-capital banks***

China has been performing the commitment of opening the financial service market step by step since entering WTO, according to the accession commitment, China promulgated new Regulation of PRC on Administration of Foreign-funded Banks (The Administrative Regulation) and its Rules for Implementation on basis of the existing PRC Administration of Foreign Financial Institutions Regulations and its Rules for Implementation in December of 2006. And the national treatment principle has been adopted in the area of market access supervision over foreign-funded banks.

The entrance of the large number of foreign banks promoted the development of Chinese financial industry, but also affected the stability of financial system, thus, how to defuse financial risks and effectively guarantee and step up the stability, persistence, security and soundness of financial industrial development is a major issue concerning the national economy and the people's livelihood, especially the supervision over market access, China has made many detailed systematic arrangements for the restriction of lawful conditions and access scale on the market access supervision on transnational banks.

#### ***3.2.1 Statutory requirement for the market Access of foreign-capital banks***

The market access condition is not only effective mean for many countries to restrict the entrance of foreign-capital banks, but it became an important tool for the supervision of those already accessed ones. There are roughly two ways for the enactment of access conditions, one is to provide national treatment to the foreign-capital banks, as in the UK and other European countries including Germany, Belgium, Luxembourg, etc., the access conditions for foreign-funded banks is same as the domestic banks; the other is to regulate access conditions that different from domestic banks for foreign-funded banks, which is using in most countries at present. The current statutory requirements for the access of foreign-capital banks include following aspects:

1) Minimum requirement for registered capital<sup>14</sup>

Banks must hold enormous capital as property warranty for creditors, which is determined by their unique management mode of debt and special influence to the national economy. Currently, the bank supervisory laws in most countries all make regulations on the minimum registered capital of foreign-funded banks.

The Regulation on Administration of our country stipulates that the minimum limit of registered capital of exclusive invested banks and Sino-foreign joint-venture banks is RMB 1000million Yuan or equivalent free convertible currency; the branches instituted by foreign-invested banks and Sino-foreign joint-venture banks in China must be appropriated with working capital gratis of no less than RMB 100million Yuan or equivalent free convertible currency by their headquarters; and branches of foreign banks must be allocated with working capital gratis of no less than RMB 200million Yuan or equivalent free convertible currency by their headquarters. The above regulations, especially the different institutional standard for capital capacity requirement of applicant from Chinese banks reflects the prudent characteristics of our country's supervision over foreign-capital banks, which is for the intention of guaranteeing the introduce of high-quality foreign capital and the stability of domestic banking industry as well as the security of depositors' capital of our country, and thus truly develop the foreign-capital banks' function in term of promotion of our economy. The registered capital should be the paid-up capital in principle, China made flexible regulations previously for introduce of foreign capitals, such as the paid-up capital of foreign-funded banks and joint-venture banks shall be no less than 50% their registered capital, this is actually the authorized capital system, but the present requirement is changed into contributed capital. At the same time, based on the demand of prudent supervision, The Regulation on Administration stipulates that the minimum limit of registered and operating capital can be raised and the share of RMB can be prescribed by banking industry supervisory management institutions of the State Council according to the needs of business scope and prudent regulation of the business-running institutions of foreign-funded banks.

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<sup>14</sup> "Regulation of the People's Republic of China on the Administration of Foreign-funded Banks", Article 8.

2) Qualifications and requirements to the administrative staff

Presently, managers of foreign-capital banks with professional knowledge and experiences are a must regulated by all countries.

China's "Regulation of the People's Republic of China on the Administration of Foreign-funded Banks" also includes clauses in this area, requires that the post qualification of directors, senior managers and chief delegates must in conformity with the conditions regulated by supervisory institution of banking industry of the State Council, and verified by supervisory institution of banking industry of the State Council. Combined with China's provisions on the managers of Chinese banks in related laws and regulations, it could be concluded that the requirements in term of foreign-bank managers is same as that of Chinese banks, the Banking Regulatory Commission is in charge of the qualification examination for the post-holding of president, vice-president, general manager and deputy general manager. The Regulation on Administration also stipulates that the replacement of directors, senior managers and chief delegates in foreign-funded banks must submitted to the regulatory institution of banking industry in the State Council for the verification of post qualification. In addition, a significant character is the regulatory authority of banking industry has the right to conduct the special supervisory measure of ordering the replacement of senior managers.

3) Requirements on forms of market access

The access forms chosen by foreign-funded banks are related directly to their legal status, and range of rights, capacities and disposing capacity, legal liabilities and extent of their being regulated, etc. If a foreign-funded bank gets access to the host country in form of branch, the head office in home country must undertake unlimited liabilities to the debt of the branch, which will be safer for the depositors but harder for the supervision in host country. If the form of sub-bank is taken for the access into host country, the foreign shareholders only have limited liabilities to the sub-banks established in the host countries within the limitation of their invested capital, this is unfavourable to the depositors in the host country, but as a independent legal person in host country, the sub-banks of

foreign-capital banks can be supervised by the host country with measures applicable to domestic banks for financial security. Therefore, it is necessary for us to select the organizing forms of market access of foreign-capital banks according to China's practical situation and needs.

In pursuance of The Administrative Regulation, there are three forms for foreign-capital banks in China, business running foreign-capital banks and wholly-owned foreign banks, foreign bank branches, Sino-foreign joint venture banks. Furthermore, representative offices can also be set up as a non-business form of foreign capital bank. At present, most business-running foreign-funded banks in China are in form of branches. In order to safeguard the security of financial system and reduce the financial risks of our country, it is regulated in law of our country the two safety measures of guarantee from headquarter of the foreign-capital bank and supervisory responsibility of home country while the access of foreign-capital bank branches into China.

#### 4) Requirements on the effective supervision of home country over the foreign-capital banks

To seek effective approach and methods for the cooperation between host country and foreign-capital banks in the home country during process of market access approval, a sound financial supervisory system in home country is required, and adequate unified supervision over foreign-funded banks must be carried out to by the parent bank. Of course, sometimes, even there is integrated supervisory system by the authority in the home country, its transnational banks may still avoid actual regulation, thus, the host country can also reject the access of foreign corporate into its domestic market. For example, Singapore rejected to ratify the BCCI establishing branches for there is no central bank for the overall supervisory responsibility; this is a practical instance of the condition.

The Regulation on Administration of our country not only regulates that the home country in which the applicants applied to set foreign-capital banks must have a perfect financial supervisory management system, and the applicants must be under the efficient regulation of the related management authority in the home country and regions, and the application must be approved by the said authority. This provision is basically in agreement with

international conventions.

5) Requirements of support from headquarters

To ensure the safe and effective operation of the foreign-capital banks and protect the interest of depositors, the headquarters of foreign-capital banks are required to appropriate minimum limitation of operating capital for their branch institutions set up in the host country. Many countries, such as the UK, US, Germany and Hong Kong, requires comfort letter or similar formal proclamation from headquarters to ensure its liability to the activities or debt of branch institutions on basis of its capital in legal forms. The Regulation on Administration of our country stipulates that, the branches set up by wholly-owned foreign banks, China-foreign joint venture banks in China must be appropriated gratis with RMB no less than 100 million Yuan or equivalent free convertible currency as operating capital, and the branches instituted by foreign-banks must be appropriated gratis with RMB no less than 100 million Yuan or equivalent free convertible currency as operating capital. And at the same time, People's bank of China regulated that a letter of guarantee from the headquarter to take liabilities for the tax and debt of the branches must be submitted while applying for the establishment of branch institutions to make clear the headquarters' obligations of debt discharge to their branches. The foreign financial institution with intentions to set up sub-banks in China must submit the debt guarantee and promise the parent bank will rescue when the sub-banks in China gets in trouble.

***3.2.2 Restrictions on the scope of market access of foreign-capital banks***

According to the "Regulation of the People's Republic of China on the Administration of Foreign-funded Banks", there are two kinds of restrictions on scope of market access for foreign banks. They are restrictions on business scope and restrictions on possible applications in regard to geographical areas. We will discuss these two topics as follows:

1) Restrictions on business scope

China's existing laws and regulations for the supervision over business of foreign-capital banks include following areas:

- Regulations on the business scope of the foreign-capital banks.

According to the business scope approved by People's Bank of China, the wholly-owned foreign banks, foreign-funded banks and joint venture banks can entirely and partially run the following businesses: Absorbing public deposits; issuing short, medium and long term loans; acceptance and discount of negotiable instrument; sale of government bonds and financial bonds, and foreign currency securities other than stocks; provide letters of credit and guarantees; handle domestic and international settlement, foreign exchange trade or agent of foreign exchange trade; exchange of foreign currency; inter-bank loan; banking card business; safekeeping business, credit investigation and advisory services; other businesses approved by People's Bank of China.

- Regulations on business restrictions of foreign-capital banks.

According to the Administrative Regulation, the foreign capital banks must fulfill 8 restrictive conditions for the performance of the above businesses, such as: the fixed assets of foreign-funded financial institutions shall not exceed 40% of its owner rights and interest; the foreign-funded financial institution must guarantee its asset liquidity; the ratio of liquid assets balance and liquid liability balance shall not be lower than 25%; necessary qualifications for running RMB business in foreign-funded financial institutions.

- Regulations on the measures and means for the supervision over foreign-capital banks.

There are mainly 6 regulations. For example: the foreign-funded financial institutions should hire Chinese CPAs who are certificated by local branch of People's Bank of China; the foreign-funded financial institutions should deliver financial statement and related materials to the People's Bank of China and its branch institution.

## 2) Restrictions on area application

The accessible regions for foreign-capital banks in China have been strictly restricted and gradually opened within a relatively long period. 4 Special Economic Zone were opened in 1985 to foreign-capital banks; and 14 coastal cities were open for the access of

foreign-capital banks in 1992; 11 inland cities including Beijing were added in 1995; and in year of 1999, the places in which business administrative bodies of foreign-capital banks can be established were extended to all the central cities other than Shanghai, Tianjing, Beijing and Guangzhou.

At present, China has cancelled all the regional restrictions to foreign-capital banks, but according to the actual distribution, they are mainly centralized in the eastern and southern coastal areas.

### ***3.3 The Improvement of China's legal system on market access of foreign-capital banks***

To counter the deficiencies of the market access system for foreign-capital banks in China combining with the national treatment principle set in WTO Rules and prudent supervisory requirements as well as our accession commitment, China has done a lot of work in area of strengthening the supervision on market access of foreign-capital banks, and approved some supervisory rules to achieve effective regulation, such as the Regulation of PRC on Administration of Foreign-invested Banks (Regulation on Administration for short), Administration of Equity Investment of Overseas Financial Institutions in Chinese-funded Financial Institutions, Measures for the Administration on Consolidated Financial Statements in Conducting Supervision over Foreign-funded Banks, but there are still gaps comparing with international systematic supervision over market access. The problems could be solved through the following respects, and thus to improve the legal system for the market access of foreign-capital banks in China.<sup>15</sup>

#### ***3.3.1 Strengthen the supervisory legislation for foreign-funded banks***

China needs not only to establish a statute system of market access suitable to the open environment, but also to improve the legislation against the new problems emerging in the market opening process, and at the same time, the rights and interests of domestic banking

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<sup>15</sup> Chen Yongrong: "On Supervision Legislation Improvement of China Foreign Capital Bank ", master's thesis in 2004 session of the Central China Normal University

industry should be protected through taking advantage of the related articles in the WTO financial service protocol so as to create an equal environment of competition. We should also integrally check up laws and regulations, improve the legal system and policies for the supervision over foreign-capital banks.

### ***3.3.2 Re-orientation of the legislative principles***

The legislation for market access of foreign banks in China is in want of clear objectives and legal principles, which is not conducive to the realization of effective regulation. Generally, China's policy basically belonged to the type of protectionism before joining the WTO, and was manifested as the obvious combination of “limitations and concessions”. The rational side of the policy is the strict restriction on the market access and business scope of foreign capital banks for the benefit protection of domestic banks, and the privileges in terms of taxation for foreign capital banks to form an impartial competitive environment with domestic banks. However, with the changes of domestic and international financial situation, in particular after China's accession to WTO, this principle is apparently difficult to adapt to the changes along with the opening of China's financial market. According to China's WTO commitment, in five years after accession, the financial businesses in foreign-funded banks will be the same with that of Chinese banks, if the preferential treatment in terms of market access and taxation to foreign-funded banks is continuously provided, it will result in a serious inequality to the domestic banks, therefore, the selection of legislative principle should be conducted mainly on basis of national treatment principle with others as supplement, and we must refer to the conventions and stick to the prudential principle to avoid the risks to the host country brought about by foreign-capital banks.

### ***3.3.3. Adjusting the requirement on the total capital for the access of foreign capital banks***

In fact, China's relaxed regulation on the minimum capital and working capital for the market access give “ultra-national treatment” to foreign-capital banks.

The Regulation of PRC on Administration of Foreign Financial Institutions prescripts that, the minimum amount of registered capital for wholly owned banks and joint venture banks is

RMB 300million Yuan or equivalent free convertible currency, and foreign bank branches must be appropriated no less than RMB 100 million Yuan or equivalent free convertible currency by the headquarter as working capital. Which is obviously a long distance from the minimum registered capital of RMB one billion Yuan for the establishment of national commercial bank regulated in the Law of PRC on Commercial Banks. Although the minimum registered capital and working capital was amended into six levels with gradual increased amount in Clause 31-36 of Implementing Rules, only the highest level concerning the minimum capital of wholly-owned banks and joint-venture bank is same as RMB 1 billion Yuan which is required in Law of PRC on Commercial Banks. This revealed the unequal treatment standards in the stage of access for Chinese and foreign banks, and the disadvantaged position of Chinese banks in competition. Therefore, the requirement on minimum registered capital and working capital of foreign banks access should be amended to no less than the level as of Chinese banks to stop the unequal “ ultra-national treatment” .

### ***3.3.4 Improving the system related to business scope and market access***

First of all, the coordination of laws on domestic commercial banks should be considered for the list of specific lines of business, a joint venture or foreign-funded bank shall not have more privileges than China commercial banks without any more restrictions. In addition, although the share proportion of the individual foreign bank as a shareholder of Chinese was currently restricted on level of no more than 20%, it hasn't been clearly stipulated in specific business areas. Such as credit card service and other retail businesses, foreign banks in talks with domestic banks have generally put forward the shareholding requirements of 50% to 50%. Since there haven't any explicit provisions on the holding proportion and access conditions in this area, the domestic banks are forced into a passive position in the negotiation. Therefore, the highest holding ratio and market access conditions for foreign-funded banks in specific businesses should be stipulated in case of their investing in Chinese banks.

Second of all, the prohibited businesses to foreign capital banks must be clearly regulated. It is paid great attention in all countries to realize restrictions on the market access of foreign-capital access through prohibitive regulations to guarantee the fulfilment of national

treatment and avoid the ultra-national treatment. The Regulation of PRC on Administration of Foreign Financial Institutions hasn't attach importance to the prohibitive mechanism with extreme limited clear interdictions on the trade of non-banking businesses, the only matter limited is the sale of stock. At the present time, the banking, security and insurance are separated in China, but many foreign banks have had a relative general mixed business experience. If the non-banking businesses are not specifically restricted by laws, it will be unequal to Chinese banks or triggering unnecessary disputes.

### ***3.3.5. Strengthening international cooperation***

An important measure to improve China's supervision on the market access of foreign-funded banks is to strengthen the international supervisory cooperation through the establishment of information sharing and exchanging system with the management authority in their home countries. The Basel Core Principles<sup>16</sup> stresses the unified global supervision over transnational banking industry, and requires wide connection between the host country and home country to expand the communication and share of information. China has made commitment to carry out the Basel Core Principle, which means our supervision over transnational banks by financial management authority must in conformity with the international conventions to enhance the international cooperation, and system related to the exchange of supervisory information with the home country of foreign-capital banks should be instituted based on bilateral and multilateral agreement for the improvement of efficiency and standard of supervision. And it should be made clear in the legislation that, the supervisory authority in home country of the foreign bank with intention of accessing into our country's financial market must reach the protocol of bilateral information exchange or understanding with Chinese regulatory authorities as the condition of access. On the other hand, the central bank of China shall enrich the departments dealing with statistic analysis as soon as possible and strengthen the collaboration between supervisory authorities in related countries to built an information exchange mechanism, and improve the system for information collection, analysis and share.

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<sup>16</sup> The Basle Bank Supervision Committee: "Documentation Compilation of the Basle Bank Supervision Committee", the China Financial Press, 2002 edition

#### 4. SUPERVISION SYSTEM ON RMB BUSINESS MANAGEMENT IN FOREIGN CAPITAL BANKS

##### ***4.1 Thoughts on the new supervision regulations from the Opening of RMB Business in Foreign Capital Banks***

In the negotiation for China's entering WTO, China make a promise in financial field: China promised to gradually open RMB business when having entered WTO. 2 years after China's entering WTO, China allowed foreign-capital banks and Chinese enterprises to do local RMB business; 5 years after the entering, China will allow foreign-capital banks to run RMB retail business.

China has already gradually opened foreign currency retail business and RMB wholesale business to foreign-capital banks and will implement "Regulations of the People's Republic of China for the Administration of Foreign-capital banks" (here after as "The Regulations" ) since Dec 11<sup>th</sup> of 2007. The regulation clearly states that the regulatory authority will remove the regional and customer limits or restrictions to foreign-capital banks for their RMB business according to the promise China made when entering WTO, and will encourage foreign-capital banks to establish branches, offices or entities in China or change their current subsidiary banks to banks that were registered as legal entities in China. Foreign-capital banks will enjoy the same benefits and treatment as Chinese banks. And right on that day, China Banking Regulatory Commission (CBRC) accepted the applications for changing the subsidiary banks to foreign-capital banks that have the status of legal entities in China applied by 8 foreign-capital banks<sup>17</sup> including HSBC, National city Bank of New York, Standard Chartered Bank, Bank of East Asia, Hang Seng Bank and so on. These 8 foreign-capital banks will provide RMB business to Chinese citizens when having finished there registration and transformation. On April 23 this year, National city Bank of New York, HSBC, Bank of East

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<sup>17</sup> "the first four Foreign-funded Banks receive shop card of enterprise",<http://www.chianews.com.cn/cj/zbjr/news/2007/03-30/903843.shtml>,2007/03/30

Asia and Standard Chartered Bank for the very first awarded China Banking Regulatory Commission (CBRC)'s approval and gained the qualification and right to provide RMB Business for Chinese citizens.

***4.1.1 One of the main points of regulations of the People's Republic of China on administration of foreign-funded banks***

Over viewing the “Regulations of the People's Republic of China for the Administration of Foreign-capital banks”, it has fully expressed China's insist in the basic state policy of reform and opening up and our attitude of strictly implementing our promises by defining the brand new business's range for foreign-capital banks meanwhile nationalizing regulatory principles. From the aspect of the opening up in banking industry, “The Regulation” includes 4 aspects of content that worth great attention.<sup>18</sup>

● RMB Business Opened Up

The unveiling of the fresh “The Regulation” will fully open RMB business to foreign-capital banks. According to Item 29 stated in “The Regulation”, foreign-owned banks and Chinese-Foreign equity joint banks will do business within the limits and range approved in” China Banking Regulatory organization in State Council of the People's Republic of China”, which covers 13 items of banking or financial business including absorbing public citizens deposits, launching loans of different terms, discounting bills, accepting bills and son on. And these banks can also provide foreign exchange settlement and sales service only with the approval by People's Bank of China. From the allowed range of business, these foreign-capital banks have already stand with Chinese banks at the same starting line for

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<sup>18</sup>The four points of “Regulation of the People's Republic of China on the Administration of Foreign-funded Banks” 2006/11/16.

<http://www.drcnet.com.cn/DRCnet.common.web/DocViewSummary.aspx?docid=1429100&leafid=14442&chnid=3767&gourl=/DRCnet.common.web/docviewforprint.aspx>

compete to win customers in the same market and share the same chances provided by the rapid development of China's economy.

For the foreign-capital banks' subsidiary banks that haven't done transformations based on the prudential regulatory principles, The Regulation defined the business range for them to be within foreign currency business and the RMB (CNY) business for customers who are not in China, and allow them to absorb no less than 1,000,000RMB deposit per citizen in China.

- Prudential Regulatory Principles Reflected

It is popular measures in other countries that "The Regulation" are taking to insist prudential principles in banking regulation and encouraging foreign capital banks to establish independent legal entity organizations in China by broadening the business range. What's more, "The Regulation" also encourages them by providing convenience for details in the process of applying for transformation based on the actual situation and conditions of foreign-capital banks.

The item 15 in "The Regulation" states that on special case or in special conditions like the approval or auditing is not able to be completed within the defined period, China Banking Regulatory organization in State Council of the People's Republic of China can properly or reasonably prolong the auditing process and period for auditing and approving the application for transformation by notifying the applicant with written notice, but the extended time must be no longer than 3 months. The applicant can go to the organization's local banking regulation organization to get an application form for opening the business with the approval document for establishment. This is a rule for buffering the actually difficulties which occurred in regulating foreign-capital banks.

According to the rule, the applicant should complete the establishment within 6months timing from the day he has received the approval for establishment. The applicant should explain the reason for the failure to complete the establishment to get the time limit prolonged for another 3 months with the approval of the banking regulation organization. For the applicant who fails to complete the establishment within the prolonged 3 months, the approval for establishment approved by China Banking Regulatory organization in State Council of the People's Republic of China will become invalid automatically.

- Foreign-capital banks' Willing Fully Respected

For different existing business shapes or forms of foreign banks in China, "The Regulation" actually follows the rules for resources, foreign-capital banks can choose to establish independent corporate bodies in China with freedom, that is, those foreign capital banks and those Chinese-Foreign equity joint banks defined in the documents are allowed to and only allowed to establish subsidiary banks or representative offices. As what to choose, it's all up to the foreign-capital banks' own need for developing their business.

It is known that, there are many countries who implement enforced policy and principles to the existing shapes or forms of foreign-capital bank, that is, all foreign banks have to establish independent legal entities or the foreign banks are forbidden in their countries. China adopted the initiative principle is out the reason for fully considering foreign capital banks' different need for self-development, as some foreign-capital banks are implementing their own development strategy that mainly focusing on developing RMB wholesale business, thus it's improper to force them to establish legal entities in China in this case.

To the foreign-capital banks who are currently unwilling to apply for establishing banks that have the status of legal entities in China, "The Regulation" defines a special principle for them, that is, foreign-capital bank's subsidiary banks can adjust their own strategy to apply for local registered banks that have the status of legal entities in China at any time.

- Foreign and Domestic Banks Treated the Same Realized in Regulatory Principles

Since it has reached consistent principles in business and customer ranges, "The Regulation" therefore insists a consistent principle in managing and regulating foreign-capital banks thus foreign-capital banks have to meet the same standards for the banking regulation and management as Chinese banks do.

As is defined in Item 40 in "The Regulation", foreign-owned banks, Chinese-Foreign equity joint banks should comply with the rules about management of asset-liability ratios written in "Law of the People's Republic of China on Commercial Banks". Foreign-capital banks' subsidiary banks' any change or transformation have to be applied or implemented by the foreign-owned banks and Chinese-Foreign equity joint banks sole-capitalized by their head

offices or the foreign-owned banks established before the birth of “The Regulation” , among which whose liability/asset ratios fall short of or breaks the rules written in “The Regulation” should improve themselves to meet the rules requirement by China Banking Regulatory organization in State Council of the People’s Republic of China .

#### ***4.1.2 The relative regulations about RMB Business management in foreign capital banks***

There are many new regulations about the RMB business management which perfect the supervision of foreign capital banks. The relative rules improve the frame and restriction of the RMB business management.

According to Article 29, we can see a wholly foreign-funded bank or a Chinese-foreign joint venture bank may, in accordance with the scope of business approved by the banking regulatory agency of the State Council, engage in part or all of the following foreign exchange and RMB businesses:

- (1) Receiving deposits from the general public;
- (2) Granting short-term, medium-term and long-term loans;
- (3) Handling acceptance and discount of negotiable instruments;
- (4) Buying and selling government bonds and financial bonds, buying and selling foreign currency securities other than stocks;
- (5) Providing letter of credit services and guaranty;
- (6) Handling domestic and foreign settlement;
- (7) Buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange;
- (8) Acting as an agent for insurance companies;
- (9) Engaging in inter-bank lending;
- (10) Engaging in bank card business;
- (11) Providing safe deposit box services;
- (12) Providing credit information services and consultancy services; and
- (13) Other businesses approved by the banking regulatory agency of the State Council.

A wholly foreign-funded bank or a Chinese-foreign joint venture bank may, with the approval

of the People's Bank of China, engage in foreign exchange settlement and sale businesses.

According to Article 31, we can see, branch of a foreign bank may, in accordance with the scope of business approved by the banking regulatory agency of the State Council, engage in part or all of the following foreign exchange businesses and RMB businesses provided to customers other than Chinese citizens within the territory of China:

- (1) Receiving deposits from the general public;
- (2) Granting short-term, medium-term and long-term loans;
- (3) Handling acceptance and discount of negotiable instruments;
- (4) Buying and selling government bonds and financial bonds, buying and selling foreign currency securities other than stocks;
- (5) Providing letter of credit services and guaranty;
- (6) Handling domestic and foreign settlement;
- (7) Buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange;
- (8) Acting as an agent for insurance companies;
- (9) Engaging in inter-bank lending;
- (10) Providing safe deposit box services;
- (11) Providing credit information services and consultancy services; and
- (12) Other businesses approved by the banking regulatory agency of the State Council.

A branch of a foreign bank may receive a time deposit of not less than RMB 1 million Yuan each sum from a Chinese citizen within the territory of China.

A branch of a foreign bank may, with the approval of the People's Bank of China, engage in foreign exchange settlement and sale businesses.

According to Article 44, 30 per cent of the operating capital of a branch of a foreign bank shall be maintained in the form of interest-bearing assets as required by the banking regulatory agency of the State Council.

According to Article 48, we can see a foreign bank that establishes two or more branches within the territory of the People's Republic of China shall authorize one of these branches to

carry out unified management of all the other branches.

The banking regulatory agency of the State Council shall conduct consolidated supervision over the branches established by a foreign bank within the territory of the People's Republic of China.

According to Article 57, we can see a representative office of a foreign bank and its staff shall not engage in any form of operational business activities.

#### ***4.1.3 The analysis on the evolution of the relative regulations***

The unveiled fresh “The Regulations” means China’s fully opening RMB (CNY) business to foreign-capital banks. And these foreign-capital banks Chinese banks can share the range in RMB (CNY) business in the same market range to compete for customers with Chinese banks.

The most distinguished characteristic of “The Regulations” is to treat banks that have the status of legal entities in China different from foreign-capital banks’ subsidiary banks. “The Regulations” implements different policies to foreign-capital banks that have the status of legal entities in China and foreign-capital banks’ offices and organization for them to get access to run retail business, that is:

Banks that have the status of legal entities in China can run all RMB (CNY) business only requiring them to “making profits in 2 years out of 3-year business” while the subsidiary banks of foreign-capital banks must get approved one subsidiary bank by one subsidiary bank and each of them are only allowed to absorb a citizen’s time deposit that exceeds 10,000 RMB; and what’s more, the banks that have the status of legal entities in China have the right to issue the bank or credit card while s subsidiary banks have no right to issue any card. The measures stated above have fully expressed and reflected the principle for keeping financial stability and proper protection over Chinese retail market. Because “The Regulations” requires a legal entity to run RMB retail business, so the foreign-capital banks who can fully open up their RMB business must be registered in China that banks that have the status of legal entities in China. This is out of the need and must for a careful regulation and monitoring the banking system in China, and this aims at enable the regulation and monitoring to be more initiative, active, effective and adequate to ensure China’s financial

system to be safe and protect the depositors' interests and benefits. Actually we learnt this prudential regulatory and monitoring measures from those implemented in similar areas or regions in USA and other Western countries. Take USA for example, most foreign-capital banks' subsidiary banks are only allowed to absorb each deposit which over 10,000 USD and the currency for running wholesale business are from the market between banks and related parties. If a foreign-capital bank wants to run retail business in USA, it firstly has to get Federal Deposit Insurance, but the banks to get Federal Deposit Insurance must be most of the subsidiaries that have the status of legal entities of the foreign-capital banks. These measures reflected the importance of prudent and prudential regulatory principles. And this is the most popular measures adopted by major developed countries for protection. Therefore, China's "The Regulations" has actually fully absorbed the regulatory experience in international banking system and industry.

#### ***4.2 Supervision defects on RMB business management in foreign capital banks***

##### ***4.2.1 Improper regulation extent***

Build up effective regulatory laws and rules for foreign-capital banks are our banking and financial industry's requirements and need for development. But to actually realize effective regulation on foreign-capital banks, banking regulatory authorities have to take related proper counter measures. As a country who is experiencing banking and financial transformation period, the limiting or pressing characteristics of our regulation on the operation of market for foreign-capital banks are fairly clear and distinguished<sup>19</sup>

As is clearly defined in "The Rules", foreign-capital banks should meet the rule that the portion between the loan and the left deposit mustn't exceed 75% as is defined in "Law of the People's Republic of China on Commercial Banks" by December 31, 2011. And for the problem of loan concentration ratio, "The Rules" requires foreign-capital banks to meet the rule that the "ratio of loan remain to the same lessee and bank capital remain mustn't exceed 10%" by December 31, 2006 as is defined in" Law of the People's Republic of China on

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<sup>19</sup> Zhang Rong: "International Comparison and Experiences Enlightenment of Foreign Capital Bank Supervision," "Economic work Journal ", 9th journal in 2003

Commercial Banks”. And what’s more, foreign capital banks have to limit loan concentration ratio to one sole big customer to be no more than 25% even in the grace period.<sup>20</sup>

“The Regulation” tends to regulate the ratio between loan and deposit and the ratio of customer concentration to meet the requirements for Chinese banks, which is a good beginning. However, the problems of this regulation are also worth thinking of.

First, in order to meet requirements for regulating the ratio of loan and deposit, foreign-capital banks will actively search for deposit in a fairly long period of time after its opening. Part of Chinese banks’ top customers will turn to invest foreign-capital banks. Normal customers will remain for Chinese banks as there are higher access limits to foreign banks. Chinese-foreign joint banks will have customers of unbalanced types.

Secondly, though foreign-capital banks have gained a proper grace period, but still they will face fairly heavy pressure. If Chinese domestic banking network of foreign-capital banks fails to absorb enough RMB deposit, they will have to limit their speed in developing loan-launching business, which will be very negative for foreign-capital banks’ fully practicing their entire capability and power, especially harmful for developing their core-competitive business.

#### ***4.2.2 Lack of unified basic method for managing and standardizing foreign-capital banks***

China is now implementing different law-creation for foreign parties and domestic parties, and the regulation for foreign-capital banks is mainly based on “The Regulation” issued by the State Council and hasn’t been improved to laws or basic, while there are “Law of the People’s Republic of China on Commercial Banks” approved by National Representative Assembly of the People’s Republic of China for regulating Chinese owned banks. The same regulatory authority are applying different levels or legal rules on foreign-capital banks and Chinese banks, which will arouse some doubt for the regulators’ being fair and reliability in implementing the laws and rules.

There is yet a weak legal rules for regulating foreign-capital banks; “Law of People’s Bank of China” and “Law of the People’s Republic of China on Commercial Bank” in combination with “The Regulation” for foreign-capital banks and together with other laws are not enough.

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<sup>20</sup> Question Answering on WTO and the Opening up of China’s Banking Industry

The prescriptions in “The Regulations” are not detailed enough which caused these lacks of proofs in the process of regulating foreign-capital banks. Therefore, it will cause negative influence on the development and construction of regulatory laws for foreign-capital banks. These problems are very serious and will directly cause the regulatory authority’s regulatory work to be at a mess and in a low effect.

#### ***4.2.3 Single regulatory method and weak control on risk***

Now the regulations and audit on foreign-capital banks will just limited to the level of auditing their accounting reports, and it is even difficult to ensure this audit sometimes as there are many reports provided by foreign-capital banks that can’t completely reflect their real and actual business activities. It’s seldom to check the real records and situation at any moment at random in foreign-capital banks or even some are done but just didn’t have the actual effect.

Thought our “The Regulation” and “The Rules” defined fairly restricted rules for foreign-capital banks’ business range, business scale, capital adequacy ratio, liability/asset ratio, and the loan ratio, the ratio of cash flow, al reserve cashes to related enterprises. But the current regulation over foreign-capital banks has not been standardized or systemized; the concept and rules for the regulation and management remain in the stage of monitoring with rules or agreements with some extent of blindness, randomness, decentralization, discontinuity, lack of systemization and the capability for pre-alarm or pre-control over risks; and lack in aspects of making effective use of regulated information, tracking risks and so on; and this has caused the rising of the regulation cost and the dependence of the effectiveness of the regulatory management, thus the risks are accumulating and spreading and will finally cause the risk-prevention work for rushing for quench the urgent “ fire”. <sup>21</sup>

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<sup>21</sup> Duan Haitao: " Issues Discussion on RMB business conducted by the China Foreign Capital Bank " and "Financial Teaching and Research", 1<sup>st</sup> journal in 2001

### ***4.3 To improve the supervision system on RMB business management in foreign capital banks to be perfect***

Practice in the transitional period reflected and indicated that adopting the policy of gradually opening-up RMB business to foreign-capital banks has not only solved the troubled situation for foreign-capital banks' business and has made an positive effect on national macro-economy policies by stabilizing and steadying RMB exchange rate, and bringing in foreign capital and investment and so on, but also dampened the huge shock of opening up RMB business to foreign-capital banks after China's entering WTO. And right because of the gradually improving and strengthening experience, skills and capability in banking regulation over foreign-capital banks RMB business , we should provide and lead foreign-capital banks' RMB business to a proper direction and provide instructions about business development regions. Due to "The Regulations", foreign-capital banks that have the status of legal entities in China can run their business in the same range as Chinese local banks enjoy. Both foreign and Chinese banks are being regulated and managed by related Chinese government departments. Therefore, guiding policy will be very important, that is, it is very critical to improve our structure and construction of our laws for banking regulations.

#### ***4.3.1 Hortatory regulatory method***

Chairman of Federal Reserve, USA, Mr. Green Spain<sup>22</sup> ever gave a simple definition for the supervisor in charge of encouraging consistent business, that is, the most important thing to do to encourage consistent business is to satisfy and guide the investors and bankers instead of violate their goal of maximum their profits and benefits. As one of the core inventions for the "New Basel Agreement" framework, IRB policy is to allow banks to use domestic risk-testing mode to regulate and control market risks.

China's regulations over foreign-capital banks should also adopt this kind of effectiveness-first and attention-to-both-every party marketing rules here. We should not ignore marketing system to distort and twist the business direction of foreign-capital banks, or we will pay a lot for our actions. We should do our best to encourage and protect

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<sup>22</sup> Zhang Yan: "Impacts and Countermeasure on De-controlling of RMB business conducted by the China Foreign Capital Bank to the China Capital Bank ", "Heilongjiang's Foreign Economy & trade", 3<sup>rd</sup> journal in 2004

foreign-capital banks to capital-requirement design, and do our best to make regulation requirement match well with foreign-capital banks' need and requirements for market.

#### ***4.3.2 Make a law for foreign-capital banks, improve current laws to be perfect***

The effectiveness of banking regulation relies on its legal systemization. At present, “The Regulation” and “The Rules” that are guiding China’s regulation over foreign-capital banks are only administrative rules and laws whose legal authority is not adequate, while other laws for banks lack of pertinence to foreign-capital banks. So, in order to promote the clear levels and stability for law construction for foreign-capital banks, it is a must to build a Foreign-capital banks Law or International Bank Law as a criterion for standardize foreign-capital banks business and marketing activities. Secondly, to make a series of special laws like Foreign-capital Bank Regulating Law as implementations for the basic law. Again, we should enforce the construction of laws and legal rules for doing our best to avoid issuing too many documents or announcements for regulations. This will strengthen the solemnity of the authority’s executing the law.

In addition, we should fully consider new features in development for Chinese banking industry and foreign-capital banks and be based on the newly issued “ The Regulation” and “ Detailed Regulations” by using judicatory explanations to established laws to make implements for them to improve the laws to be perfect, especially enforce the feasibility and avoid leaks in implementations and enterprise management, cross-border transactions, capital transferring, and the management by its mother bank for its organizations and offices in China.

#### ***4.3.3 Adjust the regulation contents and improve regulation measures***

March 22, 2007, China Banking Regulatory Commission (CBRC) published The Opening-up Report for the Banking System/Industry in China and in which it announced that China will continuously improve the regulation system for foreign capital banks in China: will adopt more systemized, deeper and more professional regulating measures to maintain the safety for

the Banking System in China.<sup>23</sup> Measures for banking regulation are varied, including regulation for admittance and for daily business. But the strict regulation for admittance mustn't replace the daily regulation for risks. For further improving the management system over daily market operation risks, we have to:

- According to the experience from international conventions and other countries , we have to clearly give different kinds of prudential safety requirement for preventing risks to foreign-capital banks, including deposit reserves, deposit securities, deposit insurances, the ratios between loan and deposit, capital adequacy ratio , current ratio , loan concentration ratio, etc. And should adjust foreign-capital banks' business accordingly.
- Build up foreign-capital banks' credit risk hierarchy and the authority will do audits periodically every year on foreign-capital banks' financial firepower, performance and achievements in China, law compliance performance, management capability, the credit status of their mother banks, and it is the motherland's regulation level for a comprehensive evaluation and score. The authority will give a ranking list by sorting these foreign-capital banks into different grades and announce the result and list via national news press media to: in one hand, supervise the bankers to enforce self-discipline, and on the other hand make it convenient to implement different levels of regulations on different banks. And the most urgent to do it to establish a complete set of feasible quantitative evaluation standard system.
- Enforce the monitoring and tracking for abnormal actions of foreign-capital banks to promote ability for risk-prevention, risk-detecting, and use the rules and laws to treat foreign-capital banks' abnormal actions.
- Adopt various types of regulations by building up a regulation rile of combining on-site and non-site inspection and auditing as well as dispatch long-term or permanent on-site auditing team to fairly large-scaled banks for regulation and controlling foreign-capital banks People's Bank of China head office or its subsidiary banks.

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<sup>23</sup> Heng Ji: " Policy Selection and Specific Measures on Effective Supervision of the China Foreign Capital Bank " and "Financial Forum", 2<sup>nd</sup> journal in 2002



## 5. THE LEGAL SYSTEM FOR INTERNAL CONTROL OF FOREIGN BANKS

The internal control system is composed of various internal control measures in a modern enterprise, it can be defined as: a series of methods, measures, formalities and procedures of control function as well as the standardized and systematic restraint mechanism formulated in the modern enterprise operational mechanism in order to regulate the constraints and inter-related relations arising from division of labour between functional departments and staff in handling various business. For the commercial banks, internal control is a self-regulatory act of the financial institutions.

The internal control system of foreign banks is the inter-related and inter-restrained systems, measures and procedures on assets management and risk prevention formed by division of duties between the internal departments and staff to achieve the established operational objectives and to ensure the security, integrity and efficiency of the financial assets, it includes regulatory control, assets management responsibilities and rights control and internal audit control, etc. Internal control system of foreign banks is of significant role in timely discovering the operational problems in foreign banks and guarding against financial risks.

### ***5.1 The Improvement of China's foreign bank internal control law system after entering into the WTO***

#### ***5.1.1 Requests from Basel Committee on banking supervision***

In recent years, Basel Committee on Banking Supervision is also becoming aware of the importance of a sound internal control system to improve the effectiveness of the international banking supervision. The issue of internal control system is mentioned in many of documents on international banking supervision and risk prevention published by Basel Committee on Banking Supervision since its founding, in September 1998, in particular, in view of the frequent international banking crisis and changes of banking risks being complicated, organizations internationalized and business diversified, the Committee issued “Internal

Control System Framework of Banking Institutions”. This is by far the first international document adopted by the Committee with comprehensive elaboration on the supervision, guidance and assessment of banks to establish effective internal control system principles. It marks the supervision on financial institutions by financial regulatory departments is shifting from capital adequacy ratio, the specific credit risk, interest rate risk and derivative financial products transactions and other specific risk targets and business types supervision to focus on supervision of establishment of comprehensive and effective risk monitoring and control system in financial institutions, it also shows that the internationally recognized banking supervisory authority - the Basel Committee on Banking Supervision has recognized the internal control deficiencies are the main reason for the banking crisis.<sup>24</sup>

With respect to the objectives of internal control system, Framework document believes that the internal control system has three main objectives:<sup>25</sup>

- 1) Operational objective, that is, effective internal control system of a bank should guarantee bank’s assets, liabilities and all other business activities can operate effectively and can effectively prevent various risks, reduce losses and lower business costs.
- 2) Information objective, that is, effective internal control system of a bank should guarantee bank policy makers at all levels to have timely and reliable access to information needed for decision-making, but also ensure the legitimate objective of shareholders, regulatory departments and other external units, that is, the internal control system should have access to the necessary and reliable information disclosure.
- 3) To ensure that the operational activities of the bank meet from time to time the changing laws and regulatory requirements and also meet the established policies and procedures inside the bank.

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<sup>24</sup> Wang Xiaobo: “On Basel Agreement and Supervision Legislation Improvement of China Foreign Capital Bank”, *Journal of the East China University*, 1<sup>st</sup> journal in 2004, Page 43

<sup>25</sup> Zhang Yu: “Legal Research on China Foreign Capital Bank Supervision”, master's thesis in 2004

***5.1.2 The perfection of internal control of foreign banks in “Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks”***

There is no reference to internal control of foreign banks in “Regulations of the People's Republic of China Governing Financial Institutions with Foreign Capital” issued by the State Council on December 20, 2001. Instead of it, “Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks” established the internal control system of foreign banks with three provisions as follows:

- 1) Article 35 regulates A business institution of a foreign-funded bank shall, pursuant to the relevant provisions, formulate operating rules of this bank, establish sound systems for risk management and internal control and comply with them. It is first to make clear that internal control is one of the three major supervision ways parallel to risk management and operational rules, indicating the important role of the establishment of internal control system in imposing supervision on foreign banks, that is, effective internal supervision measures are the important prerequisite to ensure the safe operation of foreign banks.
- 2) Article 54 regulates a solely foreign-funded fund or Sino-foreign equity joint bank shall set up independent systems of internal control, risk management, financial accounting, and computer information management. The status of internal control system in the actual operational process is established on the level of the internal structure of foreign banks, showing the internal control system is the independent system parallel to risk management system, financial accounting system and computer information system, only there four major systems orderly coordinate and cooperate can the normal operation of foreign banks be ensured and thus the financial stability of the host nation and the home nation be ensured.
- 3) Article 55 regulates the chairman of the board of directors and the senior managers of a solely foreign-funded bank established within the People’s Republic of China by a foreign bank shall not concurrently assume the position of a senior manager of a branch of foreign bank engaging in the wholesale business of foreign exchange, and vice versa. The concretion of “ Dual-person principle” . The so-called “Dual-person principle” is one

of the four main contents of internal control stipulated in “Core Principles on Effective Banking Supervision” of Basel Committee, which includes the separation of different duties of bank staff, cross check, dual assets control and dual signature, etc. This provision makes up a major defect of supervision of foreign banks in China, institutionally guarantees the transparent operation of the management level, helps change the past “dictatorial rule” type of bad management habits, can stimulate the collective wisdom of team work and effectively prevents and controls the occurrence of risks.

## ***5.2 The defects of internal control system of foreign banks***

Although Regulations have a major breakthrough in the establishment of the internal control system, the specific provisions still have some problems and are less than sufficient, just like internal control department lacks independence and power, risk assessment is lagging behind. According to “The Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks”, we can analyse as following:

### ***5.2.1. Too principle-oriented, lack of specific system design***

the Article 54, Article 35, Article 55 in the “Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks” only stipulate the establishment of the internal control system of foreign banks, the role and status of internal control mechanism in the practical operation of foreign banks and “Dual-person principle”, these three provisions are inevitably too brief and principle-oriented in the specific practice of supervision on foreign banks, the possibility of operation is not strong.

### ***5.2.2. Lack of provisions on international supervision cooperation***

Compare with the general domestic commercial banks, foreign banks are under the dual supervision of its home nation and host nation, and their internal supervision system must meet the relevant standards of its home nation as well as the host nation. In practice, as the home nation and the host nation of foreign banks often raise different requirements on the

commercial banks, which makes foreign banks face many problems in building their internal supervision system.

### ***5.2.3. Lack of relevant supervision experiences***

The supervision of China's banking supervision authority on internal control system of banks lacks adequate capacity to evaluate whether the internal control system is complete or not, weak prior risk control imposes insufficient supervision on internal control system of banks, the middle supervision lacks strong corrective measures on the loopholes discovered in the internal control system and the implementation and the amends afterwards are inadequate, this also weakens the internal control system of foreign banks. For example, with respect to the internal audit system, an important aspect of the internal control system, many foreign banks are relatively weak, mainly as many business-oriented institutions do not set up the internal audit department, lack experienced auditors, in addition, because many foreign banks are established not long, the business is not big, out of consideration of cost, they have no internal audit staff or professional audit staff and rely more on the part-time staff or the audit of the head office or the external audit forces.

### ***5.3 The suggestions of improvement the legal system for Internal control of foreign banks***

The internal control culture has not yet been established, internal control department lacks independence and power, risk assessment is lagging behind, there are no sound systems, information exchange is insufficient and internal control laws and regulations have not formed their system. This makes China's commercial banks have inability to achieve their business objectives and prevent risks. Therefore, it is the top priority to strengthen the internal control building.

In order to make the supervision capacity of our country on foreign banks in line with the general international practice, the establishment of the internal control mechanism referring to the consistent with the relevant documents of Basel Committee is not only the only way to the internal supervision mechanism in foreign banks but also s shortcut. The specific internal

supervision of foreign banks can be built with the following system framework:<sup>26</sup>

- 1) Sound decision-making organs. Decision-making organs should be fully aware of and promptly correct the problems in internal control, which is the important standard to evaluate their performance.
- 2) Appropriate separation of department duties, which is concrete manifestation of independence of the internal control.
- 3) All of the foreign banks should set up internal audit department and assign full-time auditors. The internal audit system is the basis of self-discipline, it coordinates with the external audit and supervision bodies to maintain the safety of the banking system and protect the interests of depositors more effectively.
- 4) Clear authorization and approval regulatory mechanism.
- 5) Information security safeguards. Establish internal control information management systems of foreign banks to ensure the information needs of internal control work.

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<sup>26</sup> Shi Jianzhong: " Legal Issues Research on China Foreign Capital Bank Supervision " and "Law Review", 6<sup>th</sup> journal in 2003

## 6. ON THE IMPROVEMENT TOWARDS THE PERFECT SUPERVISION OF THE FOREIGN BANKS IN CHINA

China began introducing foreign banks since 1979, after 20 years of development, the foreign banks in China has begun to take shape. China officially joined WTO on December 11, 2001. It has been inevitable to further open the financial market. The People's Bank of China also promised on December 9, 2001 in "Announcement of the Peoples Bank of China on Relevant Issues Concerning the Market Entry of Financial Institutions with Foreign Investment" to gradually open banking sector after China's WTO entry. To this end, China amended "The Regulations of the People's Republic of China Governing Financial Institutions with Foreign Capital" on December 12, 2001. In accordance with the regulation, almost all financial business has been or will soon be open to foreign financial institutions. On April 28, 2003, China Banking Regulatory Commission was officially set up. After that, China Banking Regulatory Commission took on the foreign bank supervision right as formerly exercised by the People's Bank of China. On December 27, 2003, China promulgated "The Law of the people's Republic of China on Regulation of and super". On March 8, 2004, China Banking Regulatory Commission published "Measures for the Administration on Consolidated Financial Statements in Conducting Supervision Over Foreign-funded Banks", two laws came into effect respectively on February 1, 2004 and April 1, 2004. The release of two new laws "Regulation of the People's Republic of China on the Administration of Foreign-funded Banks" and the Implementation in 2006 are not only the latest achievements of China's financial system reform, but also the important measures to adapt to the new opening situation of financial market after China's entry into WTO; And is as well the legal basis for the supervision system of foreign banks and will have far-reaching significance in supervision on foreign banks in China.

It can be seen that after 10 years of exploration and practice, China has established a set of prudent and comprehensive foreign bank supervision systems. But with the passage of time

and progress in financial globalization, the existing supervision system gradually revealed its unreasonable side. With the deepening of domestic reforms and the opening expansion, the Government is gradually fulfilling the commitment to further open up the domestic financial market, fully opened the domestic market to foreign banks, and lifted restrictions of region and service targets from foreign banks, allowed them to operate Renminbi retail business and fully implemented national treatment. This has given foreign banks opportunities to invest and develop in China. While promoting domestic banking system reform and improving efficiency of domestic banking, the rapid development and overall expansion of foreign banks in China raised higher requirements on legal supervision on foreign banks. With respect to the new situation, our country's legal supervision system on foreign banks needs to be improved from aspects of legislation, institutional system, supervision approach and supervision contents.

### ***6.1 Legal supervision system of foreign banks at present***

Legal supervision system of foreign banks refers to the combination of a set of institutional framework and legal mechanisms imposed on the financial activities of foreign banks to achieve specific socio-economic objectives. From a global perspective, legal supervision of foreign banks has three main systems, highly centralized legal supervision system, the double-level and multi-start legal supervision system and the single-level and multi-start legal supervision system. The highly centralized legal supervision system refers to legal supervision and management system under the charge of a single management body, which is adopted by most of the countries around the world; the double-level and multi-start legal supervision system refers to financial supervision system under the joint charge of several management bodies established by the central and local levels, which is mainly adopted by the federal states represented by the United States; The single-level and multi-start legal supervision system is the legal supervision system on foreign banks under joint charge of several management bodies established at the central level. After years of financial supervision practice, on the basis of constantly summing up experiences, China gradually established a single-level and multi-start legal supervision system on foreign banks. In recent years, with the rapid economic development and increase in social demand, China has

successively promulgated “Law of the People's Republic of China on the People's Bank of China” and a series of laws, rules and regulations, and made further amendments and improvements in the laws and regulations closely related to foreign bank supervision. Under these laws and regulations, under the premise of mixed and separated business, China initially established foreign banks legal supervision system. From the organizational system level, currently China has formed diversified legal supervision systems under joint exercise of financial supervision function by the People's Bank of China, China Banking Regulatory Commission, Securities and Futures Commission and China Insurance Regulatory Commission. From the contents level, the legal supervision over foreign banks mainly includes three aspects, namely, market access management over foreign banks, supervision and inspection over business activities of foreign banks and disposal and supervision over foreign banks with problems. From the index system level, in order to facilitate the supervision body to conduct on-site inspection and off-site supervision over the business activities of foreign banks, the legislature and supervision bodies also developed a series of legal supervision indicators, such as capital adequacy ratio, individual loan ratio, provision fund rate, the call money rate, the deposit-loan ratio, the ratio of foreign exchange assets and interest recovery rate, etc.

## ***6.2 The limitation of Legal supervision system of foreign banks presently***

### ***6.2.1 Option of supervision models of foreign banks***

1. According to the decision of first meeting of the 10th National People's Congress, the CBRC has been formally established, that is to say, the original banking supervision powers under the central bank will be handed over to CBRC, so that banking, securities, insurance – the framework of “separate operation, separate supervision” of China's financial industry will eventually completed. Objectively speaking, the move is no doubt a major advancement in China's financial reform process; it will provide effective protection for the reform process of financial banks and is also an appropriate move in line with China's current national conditions. However, in the long run, whether the establishment of CBRC can better solve various deep-seated problems faced by our country's immature financial markets, about which

we can not be blindly optimistic.

After the founding, CBRC replaces the People's Bank of China to exercise the supervision of foreign banks. However, in practice, the relevant bodies of the State Council also participate in the management. This has resulted in multi-start management, unclear division of labour, different regulatory standards, lack of coordination and other contradictions, affecting the effectiveness and authority of the regulatory bodies. In addition, CBRC was set up on April 28, 2003, "Law of the people's Republic of China on Regulation of and super" were officially implemented on February 1, 2004, which marks our country's separate operation and separate supervision system has been taken shape. China imposes separate operation and separate management over domestic banks, but allows mixed operation by foreign banks, under the situation of separation between banking, insurance and securities and there is no effective cooperation mechanism, it is inevitable that some business of foreign capital will be free from the supervision system, regulatory vacuum is there undermining the safety and soundness of the financial system.

### ***6.2.2 The perfection of legislation system on foreign bank supervision***

Regulatory legislation lags behind. With the business infiltration between financial institutions, the advancing progress of foreign financial institutions entering China, as well as online banking business development, the emergence of the allowed stock mortgage loans and other new circumstances, China's existing financial laws and regulations have been significantly lagging behind the financial development practice. Especially the supervision regulations on foreign banks are quite inadequate, there is no a basic law adjusting and regulating foreign banks. As mentioned above, the main basis of China's foreign banking supervision is "The Regulations of the People's Republic of China Governing Financial Institutions with Foreign Capital", as the administrative regulations, the level of effectiveness is too low. The newly released "Law of the people's Republic of China on Regulation of and supervision over the Banking Industry" is by no means a legislation specific to foreign banks, while the basis of Chinese-funded commercial banks supervision is "The Law of the People's Republic of China on Commercial Banks". The inconsistency of effectiveness level of the supervision law relied on by the same regulatory authority towards foreign banks and Chinese

banks tend to make the supervised doubt the fairness and the reliability of law enforcement of the regulatory authority. There is still blank area in the laws and regulations supervising foreign banks.

The regulatory legislation is too principle-oriented and is not systematic.<sup>27</sup> China's banking laws only have macro provisions on supervision but no specific implementation rules guiding the enforcement in terms of market access, off-site supervision, on-site checks and other aspects. Moreover, China's current financial supervision laws lack coordination between each other, Many laws and regulations developed before the release of "The Law of the People's Republic of China on Commercial Banks" and "Law of the People's Republic of China on the People's Bank of China" are incompatible with the above-mentioned two laws to different degrees, which explains our country has no systematic planning on the basic legislation on banking supervision, making the laws developed hard to form a relatively sound legal system.

As China's legislation on foreign bank supervision is lagging behind, it is difficult to effectively regulate the conduct of foreign banks by legal means, plus the long-standing shortcomings of administrative supervision concept, leading to the inadequate intensity of foreign bank supervision. China should speed up the amendments to supervision legislation on foreign banks, it is not just to clean up the existing financial laws, regulations and other regulatory documents, the more important is to learn from the advanced experience of international supervision, in line with the specific conditions of our country, to develop the special laws to improve the foreign bank supervision legal system. It is proposed the NPC Standing Committee shall enact a Regulation on the Administration of Foreign-funded Banks specific to foreign banks supervision and management duties and setting out clear and specific provisions on foreign banks access, operation and withdrawal. As for some possible and specific technical problems in practice, the State Council or banking supervision bodies under the State Council can be authorized to formulate the corresponding implementation measures or implementation rules. In this way a rationally level-structured and coordinated

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<sup>27</sup> Ni Wufan: "Ideas on Improving the supervision legislation of the China Foreign Capital Bank", *Modern Finance - Journal of the Tianjin Finance & Economics University* 7<sup>th</sup> journal in 2003

foreign bank regulatory legal system with the existing “The Law of the People's Republic of China on Commercial Banks” and “Law of the people's Republic of China on Regulation of and supervision over the Banking Industry” as basis, “The Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks” as the principal part and the corresponding implementation rules or measures as supplement can be formed.

### ***6.2.3 The approach of foreign bank supervision***

The regulatory approach is mainly external legal supervision, and external legal supervision is mainly government regulation. But the current administrative supervision means still have many hidden dangers and are hard to adapt to the complex financial regulatory environment after joining WTO, which are mainly reflected on the following aspects:<sup>28</sup>

1) Banking supervision focuses more on on-site supervision but less on off-site supervision. In the current banking supervision, the regulatory authorities often use human force tactic, relying on account check to discover problems, which not only increases the regulatory costs but also is not helpful for the banking business innovation. The foreign banks audit is more obviously lagging behind the reality of the development needs. China should follow the specific norms and procedures of auditing to timely discover the possible irregularities, violations and questionable points in the business activities, and conduct targeted spot checks on the business risks discovered by on-site inspection to realize fast and comprehensive supporting supervision and control.

2) Social supervision is insufficient; the role of social intermediary is not given full play. In the United States and other countries with mature financial supervision, the external audit is an important force in financial supervision. In China, however, the certified accountants, auditors and other intermediary organization are just in their start-up period, they have not played their due role in banking supervision.

In addition, the contents of China’s legal supervision on foreign banks are mainly agencies

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<sup>28</sup> Wang Zhaoxin: "Supervision Ideas and Practices of the China Foreign Capital Bank ", "China's Finance", 2<sup>nd</sup> journal in 2003

and the business examination and approval, their role is very limited, foreign bank risk regulation is almost empty.

### ***6.3 Perfection of Legal supervision system of foreign banks in China***

#### ***6.3.1. From the legislative level build a comprehensive system of laws and regulations on foreign bank supervision.***

Set out detailed provisions on the supervision objectives, supervision principles of foreign banks, market access conditions, operations and risk management, market withdrawal conditions and violations handling and ensure these provisions conform to the required scientific and stable and feasible features, so that the regulation has laws to go by.

The formulation of Regulation on the Administration of Foreign-funded Banks can make the contents have certain degree of “forward-looking” and operability. Such a unified foreign bank regulatory law not only can avoid vacuum and loopholes arising from division of labour, coordination and cooperation on supervising the mixed business of foreign banks by the banks, insurances and securities regulatory bodies, but also can avoid discovering the legislative shortcomings of “a matter” has “a law”. A high-quality Regulation on the Administration of Foreign-funded Banks not only facilitates the supervision of regulators in accordance with the law, but also is conducive for the supervised to abide by law consciously.

#### ***6.3.2. Strengthen joint supervision between domestic and international supervision bodies.***

1) Make clear the independent status of CBRC, establish the cooperation mechanism among the various regulatory bodies, with respect to the aforementioned government agencies affect the independent regulatory status of CBRC, China should further clarify the independent status of CBRC, government agencies shall not take part in supervision, in addition, an effective cooperation mechanism between CBRC, CIRC and SFC shall be established.

2) While strengthening domestic joint supervision, strengthen exchanges and cooperation with international supervision organizations. With the development of China’s commercial banks, cross-border supervision is more and more important. Therefore, it is absolutely necessary to set up a system of regular consultations and exchanges with the regulatory authority of every

country to inform the operation and risk degree of the body on each side to eliminate regulatory vacuum of cross-border activities of banks. At the same time, China's regulatory authorities can made extensive and in-depth study on the latest achievements of foreign banks and the supervision, in line with China's actual situation of financial economy, improve China's banking supervision and prevent financial risks from happening.

In short, under the coexistence circumstances of the current financial separate and mixed business, strengthening the exchanges and cooperation between the regulatory bodies can create good conditions for China's regulatory approach to gradually and smoothly transit to mixed business mode and provide strong guarantee of China's financial security during the transition period.

***6.3.3. At the level of supervision content strengthen supervision over the operation of foreign banks to make up for the legal regulation over market withdrawal of foreign banks.***

In terms of China's present reality, China's existing legal supervision on foreign banks mainly focuses on market access regulation, market operation supervision is weak and market withdrawal regulation is almost empty. Sound legal supervision system of foreign banks shall consider strengthen the whole regulatory process, strengthen specifically the supervision over the operation of foreign banks and further improve the legal regulatory system of market withdrawal of foreign banks.

***6.3.4. Apply the comprehensive international supervision means***

With China's further opening up of financial markets, a large number of foreign banks will flock to China. The objective situation requires China's banking supervision means to catch up with the international practice to reach the international advanced level as soon as possible.

In on-site inspections, the focus is to develop a standardized on-site inspection procedures and methods, clarify inspection targets and contents and to conduct active management and control over the entire process of on-site inspection. Timely apply regulatory measures to rectify the risks and irregularities found in inspections. With respect to control over the

inspection process of foreign banks, make clear the internal division of labour of the regulatory bodies, strengthen mutual coordination and cooperation; With respect to inspection contents, make clear risk inspection force of foreign banks and regulate assessment and monitoring procedures towards foreign banks; With respect to inspection methods, an inspection system with qualitative analysis and quantitative assessment in accordance with international practice should be established; After each inspection, give a comprehensive evaluation according to the assessment results, and then determine the appropriate supervision measures of foreign banks depending on the different circumstances. According to “The Regulation of the People’s Republic of China on the Administration of Foreign-funded Banks”, once the branches of foreign banks become the independent legal entities registered domestically, they will face more stringent requirements on registered capital, capital adequacy ratio, the same loan ceiling and other risk management aspects. At the same time, after becoming corporate bodies, as local banks, their credit guarantee from the parent banks will be weakened, this series of changes require the banks hoping identify change to be stronger on risk management and control, internal management and other areas and also raise higher demand on the supervision responsibilities and capacity of China’s supervision authorities. In off-site supervision, we should actively learn from and use international regulatory practices and international accounting standards and consolidate off-site banking supervision evaluation system. Apply computer monitoring software, electronic networks and other advanced means to collect and check data and to generate risk monitoring indicators value for risk analysis and testing, risk assessment and early warning to ensure the accuracy of information disclosure.

## 7. CONCLUSIONS

After over 20 years of exploration and practice, China has established a relatively perfect system for foreign-funded bank supervision, according to the accession commitment, especially China promulgating new Regulation of PRC on Administration of Foreign-funded Banks (The Administrative Regulation) and its Rules for Implementation on basis of the existing PRC Administration of Foreign Financial Institutions Regulations and its Rules for Implementation in December of 2006.

But there is still a long way to go comparing with the requirements of WTO for financial system and the financial service industry in developed country, and still many deficiencies that mainly reflected in market access, supervisory patterns, content and forms in term of regulation on foreign-funded banks, such as the low legislative level and effective grade of the related laws, and lack of authority of law; the unclear supervisory object of the prudent laws and regulations, insufficient risk supervision and imperfect access restrictions. We must narrow the distance between our legislation and the requirements of WTO rules, otherwise, it will be difficult for China to conduct a practical intendency to foreign-funded banks, and guarantee a stable order and healthy development of financial industry.

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## ANNEX

### **Regulations of the People's Republic of China on Administration of Foreign-funded Banks<sup>29</sup>**

Chapter I General Provisions

Chapter II Establishment and Registration

Chapter III Scope of Business

Chapter IV Supervision and Regulation

Chapter V Termination and Liquidation

Chapter VI Legal Liability

Chapter VII Supplementary Provisions

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<sup>29</sup> <http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=20080116D0F770B46656D8DAFF4313B4992E4E00>

Chapter I  
General Provisions

Article 1 – These Regulations are formulated for the purpose of meeting the needs of opening up to the outside world and economic development, strengthening and improving supervision and regulation over foreign-funded banks, and promoting safe and sound operation of the banking industry.

Article 2 – The term “foreign-funded bank” in these Regulations means any of the following institutions that are approved to be established within the territory of the People’s Republic of China in accordance with the relevant laws and regulations of the People’s Republic of China:

- (1) A wholly foreign-funded bank funded solely by a foreign bank or jointly with any other foreign financial institution;
- (2) A Chinese-foreign joint venture bank jointly funded by a foreign financial institution with a Chinese company or enterprise;
- (3) A branch of a foreign bank; or
- (4) A representative office of a foreign bank.

The institutions listed in subparagraphs (1) through (3) of the preceding paragraph are hereinafter collectively referred to as operational foreign-funded banks.

Article 3 – The term “foreign financial institution” in these Regulations means a financial institution that is registered outside the territory of the People’s Republic of China and is approved or licensed by the financial supervisory authority of its home country or region.

The term “foreign bank” in these Regulations means a commercial bank that is registered outside the territory of the People’s Republic of China and is approved or licensed by the financial supervisory authority of its home country or region.

Article 4 – A foreign-funded banks shall abide by the laws and regulations of the People’s Republic of China, and shall not harm the national, social and public interests of the People’s Republic of China.

The legitimate activities and lawful rights and interests of a foreign-funded bank are protected by the laws of the People’s Republic of China.

Article 5 – The banking regulatory agency of the State Council and its local offices (hereinafter collectively referred to as the banking regulatory agency) are responsible for exercising supervision and regulation over foreign-funded banks and their activities. Where it is provided in laws or administrative regulations that the supervision and regulation over foreign-funded banks and their activities are exercised by any other supervisory department or institution, these provisions shall prevail.

Article 6 – The banking regulatory agency of the State Council may, on the basis of the regional economic development strategy and related policies of the State, introduce encouraging and guiding measures, which shall be reported to and approved by the State Council before implementation.

## Chapter II

### Establishment and Registration

Article 7 – The establishment of a foreign-funded bank and its branch shall be subject to examination and approval by the banking regulatory agency.

Article 8 – The minimum registered capital for a wholly foreign-funded bank or a Chinese-foreign joint venture bank shall be RMB 1 billion Yuan or an equivalent amount in convertible currencies. The registered capital shall be paid-in capital.

Where a wholly foreign-funded bank or a Chinese-foreign joint venture bank establishes a branch within the territory of the People’s Republic of China, the branch shall receive from its

parent bank a non-callable allocation of not less than RMB 100 million Yuan or an equivalent amount in convertible currencies as its operating capital. The total amount of operating capital allocated from a wholly foreign-funded bank or a Chinese-foreign joint venture bank to all its branches shall be no more than 60 per cent of the parent bank's aggregate capital.

A branch of a foreign bank shall receive from its parent bank a non-callable allocation of not less than RMB 200 million Yuan or an equivalent amount in convertible currencies as its operating capital.

The banking regulatory agency of the State Council may, based on the business scope of an operational foreign-funded bank and the need of prudential supervision, increase the minimum requirement for the registered capital or operating capital and determine the RMB-denominated proportion of capital.

Article 9 – The shareholder of a proposed wholly foreign-funded bank or a proposed Chinese-foreign joint venture bank, and the foreign bank planning to establish a branch or a representative office shall satisfy the following requirements:

- (1) Having persistent profit earning capacity and good reputation, and having no record of material violation of laws or regulations;
- (2) the shareholder of a proposed wholly foreign-funded bank, the foreign shareholder of a proposed Chinese-foreign joint venture bank, and the foreign bank planning to establish a branch or a representative office, shall have the experience in engaging in international financial activities;
- (3) Having in place effective systems of anti-money laundering;
- (4) the shareholder of a proposed wholly foreign-funded bank, the foreign shareholder of a proposed Chinese-foreign joint venture bank, or the foreign bank planning to establish a branch or a representative office is under effective supervision by the financial supervisory authority of its home country or region, and the application thereof is approved by the financial supervisory authority of its home country or region; and
- (5) Other prudential requirements prescribed by the banking regulatory agency of the State Council.

The home country or region of the shareholder of a proposed wholly foreign-funded bank, the foreign shareholder of a proposed Chinese-foreign joint venture bank, or the foreign bank planning to establish a branch or a representative office shall maintain a sound financial regulatory system, and the financial supervisory authority of such country or region has well developed a supervisory cooperation mechanism with the banking regulatory agency of the State Council.

Article 10 – The shareholder of a proposed wholly foreign-funded bank shall be a financial institution and satisfy the requirements provided for in Article 9 of these Regulations. In addition, the sole shareholder or the controlling shareholder shall satisfy the following requirements:

- (1) Being a commercial bank;
- (2) Having maintained a representative office within the territory of the People’s Republic of China for at least two years;
- (3) Having the total assets of not less than US\$10 billion at the end of the year prior to the submission of the application; and
- (4) Having the capital adequacy ratio that meets the requirements prescribed by the financial supervisory authority of its home country or region and the banking regulatory agency of the State Council.

Article 11 – The shareholder of a proposed Chinese-foreign joint venture bank shall satisfy the requirements provided for in Article 9 of these Regulations. In addition, the foreign shareholder and the sole or principal Chinese shareholder shall be a financial institution, and the sole or principal foreign shareholder shall also satisfy the following requirements:

- (1) Being a commercial bank;
- (2) Having maintained a representative office within the territory of the People’s Republic of China;
- (3) Having the total assets of not less than US\$10 billion at the end of the year prior to the

- submission of the application; and
- (4) Having the capital adequacy ratio that meets the requirements prescribed by the financial supervisory authority of its home country or region and the banking regulatory agency of the State Council.

Article 12 – A foreign bank planning to establish a branch shall satisfy the following requirements in addition to those provided for in Article 9 of these Regulations:

- (1) Having the total assets of not less than US\$20 billion at the end of the year prior to the submission of the application;
- (2) Having the capital adequacy ratio that meets the requirements prescribed by the financial supervisory authority of its home country or region and the banking regulatory agency of the State Council; and
- (3) Having maintained a representative office within the territory of the People’s Republic of China for at least two years where the foreign bank applies to establish its first branch.

Article 13 – Where a foreign bank establishes an operational bank within the territory of the People’s Republic of China, it shall not establish any new representative office if it has already maintained a representative office, with the exception of the establishment of a representative office in an area covered by the regional development strategy or other related policies of the State.

Where a representative office is approved to be changed into an operational bank, the formalities for cancellation of registration of the original representative office shall be gone through in accordance with law.

Article 14 – To establish an operational foreign-funded bank, an application shall be made first for the preparation for its establishment and the following application documents shall be submitted to the banking regulatory agency in the place where the proposed bank is to be located:

- (1) an application letter, the contents of which include but not limited to the name, location, registered capital or operating capital of the proposed bank and the kinds of business it applies to engage in;
- (2) The feasibility study report;
- (3) The draft articles of association of the proposed wholly foreign-funded bank or Chinese-foreign joint venture bank;
- (4) The business contract signed by all shareholders of the proposed wholly foreign-funded bank or Chinese-foreign joint venture bank;
- (5) The articles of association of the shareholder of the proposed wholly foreign-funded bank or Chinese-foreign joint venture bank, or of the foreign bank planning to establish the branch;
- (6) the organizational chart and the name list of principal shareholders, overseas establishments and associated enterprises of the shareholder of the proposed wholly foreign-funded bank or Chinese-foreign joint venture bank, or of the foreign bank planning to establish the branch and its parent group;
- (7) The annual reports for the most recent three years of the shareholder of the proposed wholly foreign-funded bank or Chinese-foreign joint venture bank, or of the foreign bank planning to establish the branch;
- (8) The anti-money laundering system adopted by the shareholder of the proposed wholly foreign-funded bank or Chinese-foreign joint venture bank, or by the foreign bank planning to establish the branch;
- (9) the photocopies of the business license or the financial services permit issued by the financial supervisory authority of the home country or region of the shareholder of the proposed wholly foreign-funded bank, or of the foreign shareholder of the proposed Chinese-foreign joint venture bank, or of the foreign bank planning to establish the branch, and the written opinions of such authority on the application; and
- (10) Other documents required by the banking regulatory agency of the State Council.

The banking regulatory agency in the place where the proposed bank is to be located shall submit the application documents together with its examination and verification opinions to the banking regulatory agency of the State Council in due time.

Article 15 – The banking regulatory agency of the State Council shall, within six months from the date of receipt of complete application documents required for the preparation for establishment of an operational foreign-funded bank, make a decision to approve or not to approve the preparation for establishment and notify the applicant of such decision in writing; if deciding not to approve the preparation for establishment, it shall give the reasons therefore. Where, in special circumstances, the banking regulatory agency of the State Council cannot complete the examination and make a decision to approve or not to approve the preparation for establishment within the time limit prescribed in the preceding paragraph, it may appropriately extend the time limit for examination and shall notify the applicant of the extension in writing; however, the extended time limit shall not exceed three months.

The applicant shall, on the strength of the document approving the preparation for establishment, obtain an application form for business commencement from the banking regulatory agency in the place where the proposed bank is to be located.

Article 16 – The applicant shall accomplish the preparation for establishment within six months from the date of obtaining the approval for preparation. Where the applicant fails to accomplish the preparation within the prescribed time limit, it shall give the reasons therefore; and with the approval of the banking regulatory agency in the place where the proposed bank is to be located, the time limit may be extended for three months. Where the applicant fails to accomplish the preparation within the extended period, the decision made by the banking regulatory agency of the State Council on approving the preparation for establishment shall automatically become void.

Article 17 – Upon accomplishing the preparation for establishment and passing the inspection, the applicant shall submit the completed form of application for business commencement and the following documents to the banking regulatory agency in the place where the proposed

bank is to be located:

- (1) The name list of the principal persons-in-charge of the proposed bank and their curricula vitae;
- (2) The power of attorney to the proposed principal persons-in-charge of the bank;
- (3) The capital verification certificate issued by a statutory capital verification institution;
- (4) The documents on security and precautionary measures and other business-related facilities;
- (5) a guaranty letter issued by the foreign bank establishing a branch, stating that it shall be responsible for all the taxes and other indebtedness the proposed branch will incur; and
- (6) Other documents required by the banking regulatory agency of the State Council.

The banking regulatory agency in the place where the proposed bank is to be located shall submit the application documents together with its examination and verification opinions to the banking regulatory agency of the State Council in due time.

Article 18 – The banking regulatory agency of the State Council shall, within two months from the date of receipt of complete application documents for business commencement, make a decision to approve or not to approve the commencement of business and notify the applicant of such decision in writing; if deciding to approve the commencement of business, it shall issue a financial services permit to the applicant; if deciding not to approve the commencement of business, it shall give the reasons therefore.

Article 19 – An approved operational foreign-funded bank shall, on the strength of its financial services permit, register with the administrative department for industry and commerce to obtain a business license.

Article 20 – To establish a representative office of a foreign bank, the applicant shall submit the following application documents to the banking regulatory agency in the place where the proposed representative office is to be located:

- (1) An application letter, the contents of which include but not limited to the name and location of the proposed representative office;
- (2) The feasibility study report;
- (3) The articles of association of the applicant;
- (4) The organizational chart and the name list of principal shareholders, overseas establishments and associated enterprises of the applicant and its parent group;
- (5) The applicant's annual reports for the most recent three years;
- (6) The applicant's anti-money laundering system;
- (7) the photocopies of the identity certification and academic degree certificate of the proposed chief representative of the representative office, his curriculum vitae and a statement showing whether or not he has committed any malpractice;
- (8) The power of attorney to the proposed chief representative of the representative office;
- (9) The photocopies of the business license or financial services permit issued by the financial supervisory authority of the applicant's home country or region, and the written opinions of such authority on the application; and
- (10) Other documents required by the banking regulatory agency of the State Council.

The banking regulatory agency in the place where the proposed representative office is to be located shall submit the application documents together with its examination and verification opinions to the banking regulatory agency of the State Council in due time.

Article 21 – The banking regulatory agency of the State Council shall, within six months from the date of receipt of complete application documents required for the establishment of a representative office of a foreign bank, make a decision to approve or not to approve the establishment and notify the applicant of such decision in writing; if deciding not to approve the establishment, it shall give the reasons therefore.

Article 22 – An approved representative office of a foreign bank shall, on the strength of the approval document, register with the administrative department for industry and commerce to obtain a business registration certificate.

Article 23 – With the exception of annual reports, the documents listed in Articles 14, 17 and 20 of these Regulations, if prepared in a foreign language, shall be submitted together with a Chinese translation.

Article 24 – With the approval of the banking regulatory agency of the State Council, a foreign bank may, under the principles of legitimacy, prudence and business continuity, change any of its branches established within the territory of the People’s Republic of China into a wholly foreign-funded bank solely funded by the parent bank. The applicant shall file an application for establishing a wholly foreign-funded bank in accordance with the conditions, procedures and requirements for application documents prescribed by the banking regulatory agency of the State Council.

Article 25 – Where a branch of a foreign bank is changed into a wholly foreign-funded bank solely funded by its parent bank, the said foreign bank may, with the approval of the banking regulatory agency of the State Council, maintain one branch undertaking foreign exchange wholesale business within the prescribed time limit. The applicant shall file an application therefore in accordance with the conditions, procedures and requirements for application documents prescribed by the banking regulatory agency of the State Council.

The term “foreign exchange wholesale business” in the preceding paragraph means the foreign exchange business services provided to the customers other than individual ones.

Article 26 – The directors, senior executives and chief representatives of foreign-funded banks shall meet the qualification requirements prescribed by the banking regulatory agency of the State Council, and their appointment shall be subject to the approval by the banking regulatory agency of the State Council.

Article 27 – Subject to the approval by the banking regulatory agency of the State Council, a foreign-funded bank shall, under any of the following circumstances, submit application documents in accordance with the provisions and register with the administrative department for industry and commerce in accordance with law:

- (1) Changing its registered capital or operating capital;
- (2) Changing its name, business premises or office premises;
- (3) Making an adjustment to the scope of business;
- (4) Changing shareholders or the proportion of their equity or stock holdings;
- (5) Making an amendment to its articles of association; or
- (6) Other circumstances prescribed by the banking regulatory agency of the State Council.

Where a foreign-funded bank intends to replace any of its directors, senior executives or the chief representative, it shall report such replacement to the banking regulatory agency of the State Council for approval of their qualifications.

Article 28 – Where a wholly foreign-funded bank or a Chinese-foreign joint venture bank changes any of its shareholders, the new shareholder shall satisfy the requirements for a shareholder provided in Article 9, 10 or 11 of these Regulations.

Subject to the approval by the banking regulatory agency of the State Council, the new shareholder may, under special circumstances, be exempted from the provisions of subparagraph (2) of Article 10 or subparagraph (2) of Article 11 of these Regulations.

### Chapter III

#### Scope of Business

Article 29 – A wholly foreign-funded banks or a Chinese-foreign joint venture bank may, in accordance with the scope of business approved by the banking regulatory agency of the State Council, engage in part or all of the following foreign exchange and RMB businesses:

- (1) Receiving deposits from the general public;
- (2) Granting short-term, medium-term and long-term loans;
- (3) Handling acceptance and discount of negotiable instruments;
- (4) Buying and selling government bonds and financial bonds, buying and selling foreign currency securities other than stocks;

- (5) Providing letter of credit services and guaranty;
- (6) Handling domestic and foreign settlement;
- (7) Buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange;
- (8) Acting as an agent for insurance companies;
- (9) Engaging in inter-bank lending;
- (10) Engaging in bank card business;
- (11) Providing safe deposit box services;
- (12) Providing credit information services and consultancy services; and
- (13) Other businesses approved by the banking regulatory agency of the State Council.

A wholly foreign-funded bank or a Chinese-foreign joint venture bank may, with the approval of the People's Bank of China, engage in foreign exchange settlement and sale businesses.

Article 30 – A branches of a wholly foreign-funded bank or of a Chinese-foreign joint venture bank shall conduct businesses within the scope of business authorized by its parent bank, and the civil liability of the branch shall be borne by its parent bank.

Article 31 – A branch of a foreign bank may, in accordance with the scope of business approved by the banking regulatory agency of the State Council, engage in part or all of the following foreign exchange businesses and RMB businesses provided to customers other than Chinese citizens within the territory of China:

- (1) Receiving deposits from the general public;
- (2) Granting short-term, medium-term and long-term loans;
- (3) Handling acceptance and discount of negotiable instruments;
- (4) Buying and selling government bonds and financial bonds, buying and selling foreign currency securities other than stocks;
- (5) Providing letter of credit services and guaranty;
- (6) Handling domestic and foreign settlement;

- (7) Buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange;
- (8) Acting as an agent for insurance companies;
- (9) Engaging in inter-bank lending;
- (10) Providing safe deposit box services;
- (11) Providing credit information services and consultancy services; and
- (12) Other businesses approved by the banking regulatory agency of the State Council.

A branch of a foreign bank may receive a time deposit of not less than RMB 1 million Yuan each sum from a Chinese citizen within the territory of China.

A branch of a foreign bank may, with the approval of the People's Bank of China, engage in foreign exchange settlement and sale businesses.

Article 32 – The civil liability of a branch of a foreign bank and its sub-branches shall be borne by its parent bank.

Article 33 – A representative offices of a foreign bank may engage in non-operational activities related to the businesses of the foreign bank it represents, including but not limited to liaison, market research and consultancy services.

The civil liability incurred by a representative office of a foreign bank in its activities shall be borne by the foreign bank it represents.

Article 34 – Where an operational foreign-funded bank intends to engage in any of the RMB businesses within the scope of business prescribed in Article 29 or 31 of these Regulations, it shall satisfy the following requirements and be subject to the approval by the banking regulatory agency of the State Council:

- (1) Having opened business within the territory of the People's Republic of China for at least three years prior to the application;
- (2) Having been profitable for two consecutive years prior to the application; and

- (3) Other prudential requirements prescribed by the banking regulatory agency of the State Council.

Where a branch of a foreign bank is changed into a wholly foreign-funded bank solely funded by its parent bank, the time limit prescribed in subparagraph (1) or (2) of the preceding paragraph shall be calculated starting from the date when the branch is established.

## Chapter IV

### Supervision and Regulation

Article 35 – An operational foreign-funded bank shall, in accordance with the relevant provisions, develop its business rules, establish sound systems for risk management and internal control, and ensure the compliance with such rules and systems.

Article 36 – An operational foreign-funded bank shall comply with the unified accounting rules of the State and the regulations of the banking regulatory agency of the State Council on information disclosure.

Article 37 – An operational foreign-funded bank shall comply with the relevant regulations of the State when issuing external debts.

Article 38 – An operational foreign-funded bank shall determine its deposit and loan interest rates and the rates of service fees in accordance with the relevant provisions.

Article 39 – An operational foreign-funded bank engaging in deposit-taking business shall deposit reserves in accordance with the regulations of the People's Bank of China.

Article 40 – A wholly foreign-funded banks or a Chinese-foreign joint venture bank shall comply with the asset-liability ratio requirement prescribed in the Law of the People's Republic of China on Commercial Banks. Where a wholly foreign-funded bank changed from

a branch of a foreign bank and solely funded by its parent bank, or a wholly foreign-funded bank or a Chinese-foreign joint venture bank established before these Regulations become effective, fails to meet the asset-liability ratio requirement, it shall satisfy such requirement within the time limit prescribed by the banking regulatory agency of the State Council.

The banking regulatory agency of the State Council may require a wholly foreign-funded bank or a Chinese-foreign joint venture bank with high risks and weak risk management to increase its capital adequacy ratio.

Article 41 – An operational foreign-funded bank shall draw loan loss reserves in accordance with the provisions.

Article 42 – A wholly foreign-funded banks or a Chinese-foreign joint venture bank shall comply with the regulations of the banking regulatory agency of the State Council on corporate governance.

Article 43 – A wholly foreign-funded banks or a Chinese-foreign joint venture bank shall comply with the regulations of the banking regulatory agency of the State Council on connected transactions.

Article 44 – 30 per cent of the operating capital of a branch of a foreign bank shall be maintained in the form of interest-bearing assets as required by the banking regulatory agency of the State Council.

Article 45 – The RMB operating capital of a branch of a foreign bank plus its RMB reserves shall be no less than eight per cent of its RMB risk assets.

The banking regulatory agency of the State Council may require a branch of a foreign bank with high risks and weak risk management to increase the ratio set forth in the preceding paragraph.

Article 46 – A branch of a foreign bank shall ensure the liquidity of its assets. The ratio of its current assets to its current liabilities shall be no less than 25 per cent.

Article 47 – The total domestic assets of a branch of a foreign bank denominated both in RMB and foreign currencies shall be no less than its total domestic liabilities denominated both in RMB and foreign currencies.

Article 48 – A foreign banks that establish two or more branches within the territory of the People’s Republic of China shall authorize one of these branches to carry out unified management of all the other branches.

The banking regulatory agency of the State Council shall conduct consolidated supervision over the branches established by a foreign bank within the territory of the People’s Republic of China.

Article 49 – An operational foreign-funded bank shall, in accordance with the relevant regulations of the banking regulatory agency of the State Council, report to the banking regulatory agency in the place where it is located on the cross-border funds flow and assets transfer of a large amount.

Article 50 – The banking regulatory agency of the State Council may, in light of the risk profile of an operational foreign-funded bank, take such special supervisory measures as issuing an order to suspend part of its businesses or to replace any of its senior executives.

Article 51 – An operational foreign-funded bank shall engage a public accounting firm established within the territory of the People’s Republic of China in accordance with law to audit its financial and accounting reports, and make a report thereon to the banking regulatory agency in the place where the bank is located. Where it intends to terminate the engagement contract with the public accounting firm, the reasons therefore shall be given.

Article 52 – An operational foreign-funded bank shall, in accordance with the provisions, submit its financial and accounting reports, statements and other related documents to the banking regulatory agency.

A representative office of a foreign bank shall, in accordance with the provisions, submit related documents to the banking regulatory agency.

Article 53 – A foreign-funded banks shall be subject to supervision and inspection conducted by the banking regulatory agency and it shall not refuse or hamper such supervision and inspection.

Article 54 – A wholly foreign-funded banks or a Chinese-foreign joint venture bank shall establish its own independent internal control system, risk management system, financial and accounting system, and computer information management system.

Article 55 – The chairman of the board of directors and senior executives of a wholly foreign-funded bank established by a foreign bank, and the senior executives of the same foreign bank's branch engaging in foreign exchange wholesale business, both within the territory of the People's Republic of China, shall not hold concurrent positions in each other's organization.

Article 56 – Transactions between wholly foreign-funded banks established by a foreign bank and the same foreign bank's branch engaging in foreign exchange wholesale business, both within the territory of the People's Republic of China, shall be in compliance with business rules, and shall not be more favorable than the terms of their transactions with any non-related parties. Such foreign bank shall provide full guaranty to the cash transactions between the aforementioned wholly foreign-funded bank and the branch engaging in foreign exchange wholesale business both established by it within the territory of the People's Republic of China.

Article 57 – A representative offices of a foreign bank and its staff shall not engage in any form of operational business activities.

## Chapter V

### Termination and Liquidation

Article 58 – Where an operational foreign-funded bank terminates its business activities of its own accord, it shall apply in writing to the banking regulatory agency of the State Council 30 days prior to the termination and, upon examination and approval, effect its dissolution or closure and proceed to liquidation.

Article 59 – Where an operational foreign-funded bank falls into insolvency, the banking regulatory agency of the State Council may order it to suspend its business and clear its liabilities within a specified time limit. Where, within the specified time limit, the bank recovers its solvency and needs to resume its business, it shall submit an application to the banking regulatory agency of the State Council for the resumption of its business; where it fails to recover its solvency upon the expiration of the time limit, it shall proceed to liquidation.

Article 60 – Where an operational foreign-funded bank is terminated as a result of dissolution, closure, cancellation of registration in accordance with law or declaration of bankruptcy, the matters related to its liquidation shall be dealt with in accordance with the relevant laws and regulations of the People’s Republic of China.

Article 61 – Upon accomplishment of its liquidation, an operational foreign-funded bank shall go through the procedures for cancellation of its registration with the registration authority within the statutory time limit.

Article 62 – Where a representative office of a foreign bank terminates its activities of its own accord, it shall effect its closure upon approval by the banking regulatory agency of the State

Council and go through the procedures for cancellation of its registration with the registration authority within the statutory time limit.

## Chapter VI Legal Liability

Article 63 – Where a party, without approval of the banking regulatory agency of the State Council, establishes a foreign-funded bank or illegally engages in the activities within the scope of business of a banking institution, the banking regulatory agency of the State Council shall have such bank or business banned. And within five years following the date of the banning, the banking regulatory agency of the State Council shall not accept the application submitted by the said party for establishing a foreign-funded bank. Where a crime is constituted, criminal liability shall be investigated for in accordance with law. Where no crime is yet constituted, the banking regulatory agency of the State Council shall confiscate the illegal income and, if the illegal income is not less than 500,000 Yuan, concurrently impose thereupon a fine of not less than one time but not more than five times the amount of the illegal income, or, if there is no illegal income or the illegal income is less than 500,000 Yuan, concurrently impose thereupon a fine of not less than 500,000 Yuan but not more than 2 million Yuan.

Article 64 – Where an operational foreign-funded bank commits any of the following acts, the banking regulatory agency of the State Council shall order it to make corrections, confiscate its illegal income, and, if the illegal income is not less than 500,000 Yuan, concurrently impose thereupon a fine of not less than one time but not more than five times the amount of the illegal income, or, if there is no illegal income or the illegal income is less than 500,000 Yuan, concurrently impose thereupon a fine of not less than 500,000 Yuan but not more than 2 million Yuan. Where the circumstances are extremely serious or no corrections are made upon the expiration of the time limit, the said agency may order the bank concerned to suspend its business for rectification or revoke its financial services permit. Where a crime is constituted, criminal liability shall be investigated for in accordance with law:

- (1) Establishing a branch without approval;
- (2) Being changed or terminated without approval;
- (3) Engaging in business activities without approval and in violation of the provisions; or
- (4) Raising or lowering deposit interest rates or loan interest rates in violation of the provisions.

Article 65 – Where a foreign-funded bank commits any of the following acts, the banking regulatory agency of the State Council shall order it to make corrections and impose thereupon a fine of not less than 200,000 Yuan but not more than 500,000 Yuan, or may order it to suspend its business for rectification, revoke its financial services permit, or cancel the registration of its representative office if the circumstances are extremely serious or no corrections are made upon the expiration of the time limit. Where a crime is constituted, criminal liability shall be investigated for in accordance with law:

- (1) Failing to disclose information in accordance with the relevant regulations;
- (2) Refusing or hampering the supervision and inspection conducted by the banking regulatory agency in accordance with law;
- (3) submitting the financial and accounting reports, statements or other related documents that are false or in which important facts are concealed;
- (4) Concealing or destroying the documents, certificates, accounting books, electronic data or other materials needed in the supervision and inspection;
- (5) Appointing a director, senior executive or chief representative without approval of his qualification; or
- (6) Refusing to implement the special supervisory measures defined in Article 50 of these Regulations.

Article 66 – Where an operational foreign-funded bank, in violation of the relevant provisions of these Regulations, fails to submit its financial and accounting reports, statements or other related documents within the prescribed time limit, or fails to develop its business rules or establish sound management systems in accordance with the provisions, the banking

regulatory agency of the State Council shall order it to make corrections within a prescribed time limit and, if no corrections are made upon the expiration of the time limit, impose thereupon a fine of not less than 100,000 Yuan but not more than 300,000 Yuan.

Article 67 – Where an operational foreign-funded bank violates the provisions of Chapter IV of these Regulations in its business operations or seriously violates other prudential business rules, the banking regulatory agency of the State Council shall order it to make corrections and impose thereupon a fine of not less than 200,000 Yuan but not more than 500,000 Yuan, or may order it to suspend its business for rectification or revoke its financial services permit if the circumstances are extremely serious or no corrections are made upon the expiration of the time limit.

Article 68 – Where an operational foreign-funded bank violates the provisions of these Regulations, the banking regulatory agency of the State Council may, in addition to the penalties provided for in Articles 63 through 67 of these Regulations, take the following actions by taking into account the specific circumstances:

- (1) ordering the said bank to remove or replace the director, senior executive or any other person directly responsible for the violation;
- (2) giving a warning to the director, senior executive or any other person directly responsible for the violation if the act of the said bank does not constitute a crime, and concurrently imposing a fine of not less than 50,000 Yuan but not more than 500,000 Yuan; or
- (3) disqualifying the director or senior executive directly responsible for the violation from holding the corresponding position within the territory of the People's Republic of China for a specified period of time or for life, or prohibiting the director, senior executive or any other person directly responsible for the violation from engaging in banking business within the territory of the People's Republic of China for a specified period of time or for life.

Article 69 – Where a representative office of a foreign bank, in violation of the provisions of these Regulations, engages in operational business activities, the banking regulatory agency of the State Council shall order it to make corrections, give it a warning, confiscate its illegal income and, if the illegal income is not less than 500,000 Yuan, concurrently impose thereupon a fine of not less than one time but not more than five times the amount of the illegal income, or, if there is no illegal income or the illegal income is less than 500,000 Yuan, concurrently impose thereupon a fine of not less than 500,000 Yuan but not more than 2 million Yuan. Where the circumstances are serious, the banking regulatory agency of the State Council shall cancel the registration of the representative office. Where a crime is constituted, criminal liability shall be investigated for in accordance with law.

Article 70 Where a representative office of a foreign bank commits any of the following acts, the banking regulatory agency of the State Council shall order it to make corrections, give it a warning, concurrently impose thereupon a fine of not less than 100,000 Yuan but not more than 300,000 Yuan and, if the circumstances are serious, disqualify its chief representative from holding the position within the territory of the People’s Republic of China for a specified period of time or require the bank represented by the office to remove or replace the chief representative. Where the circumstances are extremely serious, the banking regulatory agency of the State Council shall cancel the registration of the representative office:

- (1) Changing its office premises without approval;
- (2) Failing to submit documents to the banking regulatory agency of the State Council in accordance with the provisions; or
- (3) Violating other provisions of these Regulations or other regulations of the banking regulatory agency of the State Council.

Article 71 –Where a foreign-funded bank violates other laws or regulations of the People’s Republic of China, the violation shall be dealt with by the relevant competent organs in accordance with law.

## Chapter VII

### Supplementary Provisions

Article 72 – These Regulations are *mutatis mutandis* applicable to the banking institutions established in Chinese Mainland by financial institutions from the Hong Kong Special Administrative Region, the Macao Special Administrative Region, or Taiwan region. However, if the State Council provides otherwise, those provisions shall prevail.

Article 73 – These Regulations shall be effective as of December 11, 2006. The Regulations of the People’s Republic of China on Administration of Foreign-funded Financial Institutions promulgated by the State Council on December 20, 2001 shall be repealed simultaneously