

## **Market Access or Market Restrictions – Analysis on the Regulations of PRC on Administration of Foreign-Funded Banks**

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## Abstract

In order to honor the commitments made on its accession into the World Trade Organization, China has opened its banking sector to foreign investment since December 11, 2006. Meanwhile, the State Council of China has promulgated the newly revised *Regulations of the People's Republic of China on Administration of Foreign-funded Banks* and China Banking Regulatory Commission has published the corresponding *Rules for Implementing the Regulations of the People's Republic of China on Administration of Foreign-funded Banks*. Although the new Regulations and Rules have ensured that the juridical-person banks with foreign fund can receive the same national treatment as that of their Chinese counterparts, they still contain some restrictions on the business of foreign bank branches. These restrictions, when examined *prima facie*, appear to be in conformity with the exception rule of prudential supervision under GATS. However, if we examine the specific commitments of China and other relevant rules, we may find that these restrictions are not so justified for prudential reasons. In other words, "prudential supervision" is not a persuasive excuse if China is challenged for these restrictive measures in the WTO dispute settlement proceedings. We suggest that China should reassess the new Regulations and Rules.

## A. Introduction

As a general rule, WTO Members are obligated to keep their laws, regulations and administrative procedures in conformity with their concessions listed in the Annexes of the *General Agreement on Trade in Services* (GATS). In view of the special difficulties of some Members in opening their service markets, GATS permits WTO Members to define the specific sectors where their market access commitments will apply under the provisions of Article XVI. Article XX of GATS provides that each Member should set out in its Schedule the specific sectors it will open for other Members after its accession into the WTO. Furthermore, each Schedule will specify: (a) the terms, limitations and conditions on the market access of foreign business; (b) the conditions and qualifications on the national treatment to foreign business; (c) the undertakings of each Member relating to its additional commitments; (d) where appropriate the

time-frame for the implementation of such commitments; and (e) the specific time when the commitments become effective.<sup>1</sup>

Since its accession into the WTO in 2001, China has opened its banking sector to foreign-funded banks according to the commitments.<sup>2</sup> Specifically, China has phased out the restrictions on the business of foreign-funded banks in China following the time-frame set out in the Schedule<sup>3</sup>. China released geographic restrictions on foreign currency business to the foreign-funded banks on the date of her accession. As for the local currency business, China had removed all geographic restrictions before the end of the transitional period, i.e. December 11, 2006. In regard to the clients of foreign-funded banks, China has extended them from Chinese enterprises to all individuals. Meanwhile, China has lifted the ban on the local currency debt of foreign-funded banks in no more than 50% of their foreign currency debt and raised the percentage for foreign-funded banks to absorb foreign currency savings in China.<sup>4</sup> Criteria for authorizing foreign-funded banks to participate in China's financial business are set solely out of prudential reasons (i.e., contain no economic-need test or quantitative limits on licenses required by Article XVI of GATS).<sup>5</sup> Any non-prudential measures, which may restrict the ownership, operation, and legal status of foreign-funded banks, have been eliminated. The restrictions on foreign financial institutions to open their branches in China no longer exist. Based on the specific commitments, China has kept her promise to

<sup>1</sup> WTO, *The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations* (1999), 298-301.

<sup>2</sup> According to Article 2 of the Regulations, the "term "foreign-funded bank" 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 relevant laws and regulations of the People's Republic of China: (1) a wholly foreign-funded bank funded by a foreign bank on its own 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; and (4) a representative office of a foreign bank."

<sup>3</sup> WTO, *Report of the Working Party on the Accession of China* (Schedule CLII – The People's Republic of China: Part II - Schedule of Specific Commitments on Services, List of Article II MFN Exemptions), Part II (Specific Commitments): Banking and Other Financial Services (excluding insurance and securities), WT/ACC/CHN/49, (1 October 2001) available at <http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan002144.pdf> (last visited 16 December 2009).

<sup>4</sup> On these two issues, the foreign-funded banks meet the same requirements as their Chinese counterparts. See Arts 29 and 31 of the Regulations.

<sup>5</sup> Art. 13 of the Rules.

grant national treatment to the qualified foreign-funded banks as that of their Chinese counterparts in supplying services in China.<sup>6</sup>

In order to substantiate those commitments in the legal form, the State Council of China promulgated the newly revised *Regulations of the People's Republic of China on Administration of Foreign-funded Banks* (hereinafter "*Regulations*") on December 11, 2006, which provides the general directions on the set-up, operation and supervision of foreign-funded banks in China. Meanwhile, China Banking Regulatory Commission (CBRC) published the *Rules for Implementing the Regulations of the People's Republic of China on Administration of Foreign-funded Banks* (hereinafter "*Rules*"), which specifies the terms, conditions and limitations contained in the provisions of the Regulations. From the contextual viewpoint, the new Regulations and Rules appear in conformity with China's commitments and follow the basic principle of national treatment.<sup>7</sup> From the viewpoint of their impact in practice, however, some of the provisions in the Regulations and Rules still have the restrictive effect on the business of some foreign-funded banks in China.

## B. Relevant Provisions and China's Specific Commitments

The Regulations take the "juridical-person bank" as the policy orientation. The juridical-person banks are referred to those foreign-funded banks, which have registered in China as Chinese juridical-person enterprises (hereinafter "juridical-person banks with foreign fund").<sup>8</sup> Specifically, they include the first two groups listed in Article 2, i.e. (1) a

<sup>6</sup> As for the business scope of the foreign-funded banks in China, see Chapter Three of the Rules.

<sup>7</sup> There are fundamental differences in terms of application under GATT and GATS. In GATT, both MEN and NT treatments are general or unconditional obligations while the GATS sets out general (unconditional) MEN obligation and specific (conditional) NT obligation.

<sup>8</sup> While the juridical-person banks with foreign fund are held responsible for losses up to the limit of their registered capital, the foreign financial institutions, which have not registered in China as juridical-person banks, will bear all the actual losses. According to Articles 12 and 13 of the Commercial Banking Law of PRC, the minimum of registered capital for a national juridical-person bank is one billion yuan, one hundred million yuan for a municipal juridical-person bank and fifty million yuan for a rural juridical-person bank. All foreign financial institutions which have registered as juridical-person banks are, so far, limited to the national ones.

wholly foreign-funded bank funded by a foreign bank on its own 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. While the juridical-person banks with foreign fund are qualified to receive the same treatment as that of their Chinese counterparts in market access, administrative supervision and business scope, the foreign bank branches and the representative offices of foreign banks which have not registered as the Chinese juridical-person enterprises (hereinafter “foreign bank branches”) will still meet some restrictions in the above aspects. The specific differences are illustrated in table one:

Table 1: Differences in legal status, registered capital, operating capital and business restrictions between a juridical-person bank with foreign fund and a foreign bank branch

	<b>Juridical-Person Bank with Foreign Fund</b>	<b>Foreign Bank Branch</b>
Legal status and risk liability	(1) Registered in China as a Chinese juridical-person enterprise. (2) Supervised mainly by the Chinese authorities. (3) Liabilities up to the level of its registered capital.	(1) The branch of a foreign bank registered outside China. (2) Supervised mainly by the authorities of the registering country or region. (3) Bearing all the actual losses.
Minimum requirement for capital registered	One billion Chinese yuan (Renminbi) or the equivalence of exchangeable foreign currency	None
Minimum requirement for operating capital	No less than one hundred million Chinese yuan (Reminbi) or the equivalent of exchangeable foreign currency appropriated by its headquarter	No less than two hundred million Chinese yuan (Reminbi) or the equivalent of exchangeable foreign currency appropriated by its headquarter
Starting level for absorbing public savings	None	No less than one million Chinese yuan (Reminbi) in each fixed deposit
Banking card business	Permitted	Not permitted

Both the juridical-person banks with foreign fund and the foreign bank branches are permitted to absorb public savings in China. The foreign bank branches, however, must accept in each fixed deposit transaction of local currency no less than one million Chinese yuan (Reminbi) while there are no such restrictions on the juridical-person banks with foreign fund. The foreign bank branches are banned from issuing banking cards including debit cards and credit cards. In this way, the Regulations and Rules have

isolated the foreign bank branches from one of the most important banking sectors in China-retailing.<sup>9</sup>

Although the Regulations and Rules do not require the registration of a Chinese juridical-person enterprise as the precondition for a foreign financial institution to open its business in China,<sup>10</sup> the reality is that if a foreign financial institution wishes to extend its business of local currency to the clients with small amounts of capital and expand its business to the banking card sector in China, it must finish such registration beforehand. In other words, to register as a Chinese juridical-person enterprise is *de facto* the precondition for a foreign financial institution to fully receive the national treatment in China. While the juridical-person-bank orientation may be explained as the “prudential supervision” measures to the fast-developed Chinese finance,<sup>11</sup> the issue whether these restrictive measures are in conformity with China’s commitments in specific and WTO rules in general is still in question.

Article XVI of GATS provides that the basic rules regulating each WTO Member on its market access of trade in services include “1. With respect to market access through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favorable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule (original note

<sup>9</sup> The CBRC explained that since a foreign bank branch is registered outside China, it is not as easy to supervise its business as that of a juridical-person bank with foreign fund. These restrictions are designed to ensure the stability of Chinese finance. M. Yan & C. Chun-lin, ‘The Banking Market Will Be Opened Next Month, Chinese Natural Persons May Put Their Money in the Foreign Financial Institution’, *Yangzhi Evening News* (17 November 2006).

<sup>10</sup> According to Article 3 of the Regulations, the “term “foreign financial institution” 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 regulatory authority of its home country or region.”

<sup>11</sup> The so-called “prudential supervision” “needs to be addressed in the wider context of financial regulation [...]” These restrictive measures relate to “paragraph 2 of the Annex on Financial Services of GATS, which states that members are not prevented from taking measures that are for prudential purposes. Thus, if a regulation is claimed to be of a prudential nature, it will not be subject to the commitments made to GATS. The prudential supervision touches upon the notion of a prudential regulation, and how this can be defined. It also concerns the way in which progressive liberalization can take place in the face of such a clause [...]” M. Yokoi-Arai, ‘GATS’ Prudential Carve Out in Financial Services and Its Relation with Prudential Regulation’, *57 International & Comparative Law Quarterly* (2008) 3, 614.

omitted). 2. In sectors where market-access commitments are undertaken, the measures which a Member shall not maintain or adopt either on the basis of a regional subdivision or on the basis of its entire territory, unless otherwise specified in its Schedule, are defined as ... (e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service”.<sup>12</sup>

As for the national treatment on trade in services, Article XVII:1 of GATS provides that “in the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers.”<sup>13</sup> In order to distinguish each mode of services illustrated in Article I:2, Article XXVIII (Definition) of GATS specifies “commercial presence” as referring to any type of business or professional establishment, including through “(i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or representative office, within the territory of a Member for the purpose of supplying a service.”<sup>14</sup> In addition to the above provisions, Article XX:2 of GATS requires that WTO Members should ascribe to all the measures inconsistent with both the market access and national treatment requirements in the column relating to Article XVI (Market Access). This ascription will be considered to provide a condition or qualification to Article XVII (National Treatment).<sup>15</sup>

China has made its specific commitments in regard to the modes of supplying services in the banking and other financial sectors (excluding insurance and securities) as the following: “(a) Acceptance of deposits and other repayable funds from the public; (b) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction; (c) Financial leasing; (d) All payment and money transmission services, including credit, charge and debit cards, travelers cheques and bankers drafts (including import and export settlement); (e) Guarantees and

<sup>12</sup> WTO, *supra* note 1, 298-299.

<sup>13</sup> Note under this Article adds: “Specific commitments assumed under this Article shall not be construed to require any Member to compensate for any inherent competitive disadvantages which result from the foreign character of the relevant services or service suppliers.” WTO, *supra* note 1, 299-300.

<sup>14</sup> WTO, *supra* note 1, 305.

<sup>15</sup> *Id.*, 301.

commitments; (f) Trading for own account or for account of customers: foreign exchange.”<sup>16</sup>

It appears that China has not distinguished in its commitments the modes of supplying services between a juridical-person bank with foreign fund and a foreign bank branch. Neither has China set in its commitments the starting level for a foreign bank branch to accept public savings. On the contrary, a foreign bank branch may take the mode of “commercial presence” to provide services listed in the commitments to all Chinese clients after December 11, 2006 (the end of the five-year transitional period).<sup>17</sup> Therefore, China cannot limit the modes of service through the types of legal entity unless these limitations are clearly inscribed in the Schedule as required by Article XVI: 2 (e) of GATS.<sup>18</sup>

Based on the above analysis, the author of this article would point out that a foreign financial institution may take the type of either a juridical-person bank with foreign fund or a foreign bank branch to supply services in China. A foreign bank branch should not be treated less favorable than other types of legal entity. To be specific, it should be permitted to accept the savings of local currency from Chinese clients without the minimum requirement in each deposit transaction and to issue banking cards in China as well. The Chinese authorities should not require the registration into a Chinese juridical-person enterprise as the precondition for a foreign financial institution to supply the above services.

### C. Empirical Research on the Regulations and Rules

As for the juridical-person-bank orientation in the Regulations and Rules, the CBRC explained that “they are the necessary measures out of supervision purposes. These measures will help the Chinese authorities to regulate the business of foreign-funded banks more conveniently, to make the supervision more effective and comprehensive, to ensure the stability of Chinese finance system and to protect the interests of depositors.” The CBRC further stated that “the requirement for a foreign bank branch to accept a fixed deposit in each transaction of local currency no less than one

<sup>16</sup> Report of the Working Party on the Accession of China, *supra* note 3.

<sup>17</sup> According to Article XXVIII (d) of GATS, “commercial presence” includes the institutional form of foreign bank branches.

<sup>18</sup> Measures defined in Article XVI:2 (e) of GATS are referred to those “which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service.” WTO, *supra* note 1, 299.



million Chinese yuan is in conformity with the WTO rules. These measures, from the perspective of prudential supervision and international practices, are not restrictions, but conveniences and benefits conferred to a foreign bank branch in providing services in China. A foreign financial institution may decide on its own whether or not to register as a Chinese juridical-person bank.” Based on these points, the CBRC concluded that these restrictive measures to a foreign bank branch are consistent with the international practices and the specific commitments made by China.<sup>19</sup>

In order to justify the above statements, the author of this article made a survey through questionnaires from February to March 2007 among all the foreign-funded banks in Shanghai.<sup>20</sup> Some of them responded to our survey cooperatively.<sup>21</sup> They include five juridical-person banks with foreign fund, two foreign bank branches and one representative office of foreign bank.<sup>22</sup> The survey includes questions concerning (a) business focus in China, (b) willingness to register as a juridical-person bank, (c) views to the juridical-person-bank orientation and restrictions on the foreign bank branches, (d) other questions relevant to the commitments made by China on banking sector liberalization.

The results indicate that the recent concentration of most juridical-person banks with foreign fund and foreign bank branches will still be on the wholesale business, i.e., the business with enterprises and each deposit is

<sup>19</sup> Yan & Chun-lin, *supra* note 9.

<sup>20</sup> Shanghai is the financial center of China and most foreign financial institutions chose this city as the first site to open their business in China. Although there is no official data available as to the total number of foreign-funded banks in China, one document published by the central government of China indicated that the total assets of foreign-funded banks in Shanghai, at the time of our survey, is 55% of that of all foreign-funded banks in China. ‘The Rapid Growth of Foreign-funded Banks in Shanghai’, available at [http://www.gov.cn/jrzg/2006-05/10/content\\_277067.htm](http://www.gov.cn/jrzg/2006-05/10/content_277067.htm) (last visited 16 December 2009).

<sup>21</sup> When we made the survey, there were eight juridical-person banks with foreign fund, eight foreign bank branches and three representative offices of foreign banks which had opened their business in Shanghai. Five juridical-person banks with foreign fund, two foreign bank branches and one representative office of foreign bank responded to our survey. The representativeness of our survey is guaranteed by the response of eight banks out of nineteen in total. They either mailed back the questionnaire to us or answered our questions through telephone. The author would like to express his thanks to the postgraduate of the law school, Shanghai Jiao Tong University, Meng Qinkai for his help in the survey.

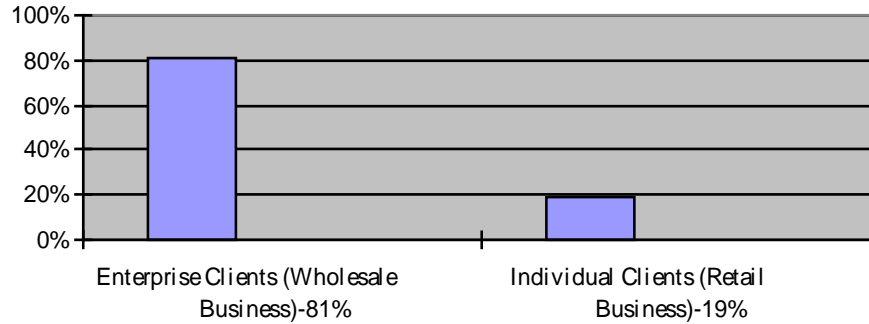
<sup>22</sup> This article has concealed the names of these foreign-funded banks to avoid any possible inconvenience upon them. The author, however, is responsible for the authenticity of the data.

usually more than one million Chinese yuan (see Table 2). As some scholars pointed out, the 1.3 billion consumers and \$1800 billion of foreign currency deposited in China are fascinating to many foreign financial institutions.<sup>23</sup> Many juridical-person banks with foreign fund have also expected to extend their business to the retailing of products of local currency, especially those with high profits such as banking cards, mortgage and personal finance. Among the eight foreign-funded banks which responded to the survey, the five juridical-person banks with foreign fund made clear that they had already started the retailing business of local currency and made a detailed plan for the future development. Although the number of juridical-person banks with foreign fund which held this view at the time of our survey is only a little more than half of the total number of this kind in Shanghai, their total registered capital is quite significant.<sup>24</sup> In addition, all of these five banks had already started their business in China even before they finished the registration and had established a large business network in China. The business of these five juridical-person banks with foreign fund constitutes the substantial part of banking business run by all foreign-funded banks in China.

<sup>23</sup> J. E. Jirak, 'Equity Investment in Chinese Banks: A Doorway into China's Banking Sector', *North Carolina Banking Institute*, (2006) 10, 329.

<sup>24</sup> According to Article 13 of the *Commercial Banking Law of PRC*, the minimum registered capital for a national bank is one billion yuan. The minimum registered capital for a city bank is one hundred million yuan. The minimum registered capital for a rural bank is fifty million yuan. All the five juridical-person banks with foreign fund, which responded to our survey, had decided to set their headquarters in Shanghai.

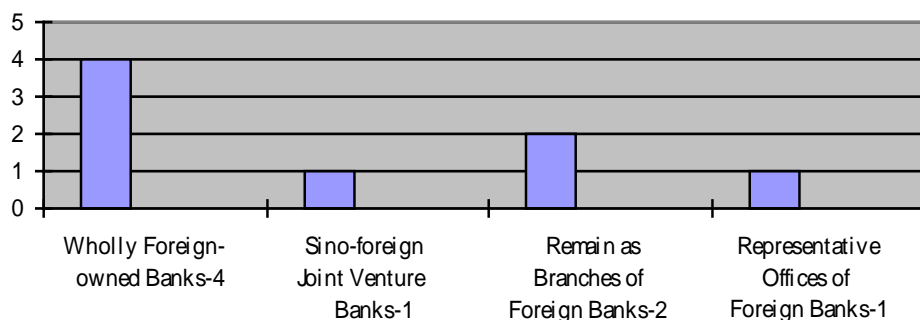
Table 2: Average percentage of business division of the five juridical-person banks with foreign fund



It appears that the decision of whether or not to register as a juridical-person bank with foreign fund is closely connected to the business focus of a foreign financial institution. Those, which focus their business on enterprise clients (wholesale business), do not consider for the time being to transform into juridical-person banks with foreign fund. They choose to be the foreign bank branches. Their operating capital mainly comes from the capital market or from their business partners. On the contrary, those wishing to extend their business to the individual clients (retail business) have finished the registration process. These juridical-person banks with foreign fund come from the United States, Japan and Hong Kong.<sup>25</sup> By accepting the deposits from individual clients, they are able to increase the sources of operating capital and reduce the cost of financing in China. Among the juridical-person banks with foreign fund, some choose the type of Chinese-foreign joint venture banks while others choose the type of wholly foreign-funded banks (see Table 3).

<sup>25</sup> For the purpose of this survey only, the PRC shall exclude Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan notwithstanding the fact that Article 72 of the Regulations provides that the provisions shall *mutatis mutandis* be applicable to the juridical-person banks, bank branches and representative offices of banks with the fund from these regions unless otherwise stated by the State Council.

Table 3: Types of the foreign-funded banks in absolute numbers, which responded to the survey

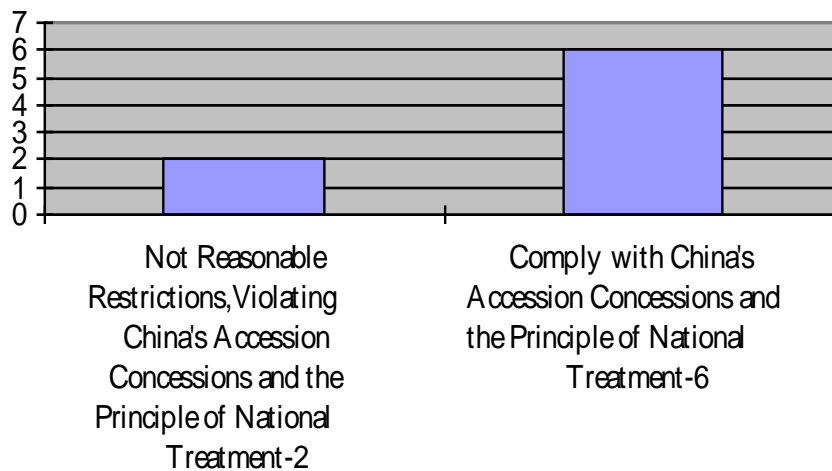


Basically, all the foreign-funded banks, which responded to our survey, agreed that China had honored the commitments made upon its accession into the WTO. Some of them, however, were of the view that the minimum requirement of one million yuan deposit of local currency from individual clients limited the business of foreign bank branches, which contradicted China's commitments (see Table 4). They also pointed out that the requirement to register to be a juridical-person bank with foreign fund before a foreign financial institution started the banking card business was not consistent with China's commitments. These restrictions would increase the operating cost of a foreign bank branch and limit its capacity of expanding business in China.

A typical question is: since China has promised to open the local currency market after the five-year transitional period, why does China require a foreign financial institution to register to be a juridical-person bank with foreign fund before it is permitted to start banking card business, or set a higher threshold in the business of individual clients for foreign bank branches? One possible answer is that China, by doing so, may exercise effective supervision on the juridical-person banks with foreign fund which are required to follow Chinese laws and regulations as their Chinese counterparts in the following aspects: supervision to the various levels of administrative management, necessity test of replenishing registered capital, criteria of supplementing managerial personnel and setting of uniform management methods.<sup>26</sup>

<sup>26</sup> As one scholar points out that there were a number of weaknesses in the Chinese legal and regulatory system before its WTO accession. Firstly, there were many gaps or

Table 4: Views on the consistency of the Regulations and the Rules with the WTO rules in absolute numbers



## D. Contributing Factors and Bottom-Line of the Prudential Measures

### I. Contributing Factors of the Prudential Measures

According to Article XVII:1 of GATS,<sup>27</sup> China should grant national treatment in the banking sector to the foreign service and service suppliers

gray areas where no suitable laws or subordinate legislation could apply. Secondly, a consistent and effective approach in enacting and amending laws was also lacking, as well as transparent procedures to bring in stakeholders' participation into the legislation process. Thirdly, enforcement laws and regulations were inadequate, and on many occasions financial sector supervisors would have to rely on the interpretation of the Supreme Court when implementing the law. Fourthly, the segregated regulatory system had overemphasized the regulations of market behaviors compared with the prudential regulations of financial institutions. Prudential supervision proves to be more difficult in a segregated system where financial institutions are engaged in cross-sector activities. These weaknesses, however, still exist even after China's accession into the WTO. L. Xuan, *Interactive Role of GATS Commitments and Dynamics of Chinese Economic Reform in the Context of Banking Liberalization* (February 2004) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=579842](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=579842) (last visited 16 December 2009), 19.

<sup>27</sup> WTO, *supra* note 1, 299-300.

subject to the conditions and qualifications specified in its commitments. Paragraph 2 (a) of the Annex on Financial Services of GATS (hereinafter “*First Annex*”) provides that notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures out of *prudential reasons* (emphasis added) to protect investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of GATS, they shall not be used as a means of avoiding the Member's commitments or obligations under GATS.<sup>28</sup> Although the First Annex does not list the measures which may be implemented for prudential reasons, Article XVII:3 of GATS contains the relevant provisions on this issue, which provides that formally identical or formally different treatment shall be considered to be less favorable if it modifies the conditions of competition in favor of services or service suppliers of the Member compared to like services or service suppliers of any other Member.<sup>29</sup> Based on these criteria, no matter what measures are promulgated by China, they will be considered as inconsistent with the WTO rules if these measures have *de facto* led the foreign legal entities in unfavorable conditions compared with their Chinese counterparts.<sup>30</sup> These measures will be challenged from other Members unless China is able to justify them for prudential reasons as permitted in paragraph 2 (a) of the First Annex.

Different from the transactions in the sales of goods, the activities of finance may be completed in the fictitious forms and separated from the real transactions, which may appear in multiples in the increasing of its profits.

<sup>28</sup> WTO, *supra* note 1, 311.

<sup>29</sup> WTO, *supra* note 1, 300.

<sup>30</sup> On the banking sector access in China's Schedule, the existing limitations remaining effective include (1) foreign financial institutions which meet the following condition are permitted to established a subsidiary of a foreign bank or a foreign finance company in China: total assets of more than US \$ 10 billion at the end of the year prior to filing the application; (2) foreign financial institutions which meet the following condition are permitted to establish a branch of a foreign bank in China: total assets of more than US \$ 20 billion at the end of the year prior to filing the application; (3) foreign financial institutions which meet the following condition are permitted to establish a Chinese-foreign joint bank or a Chinese-foreign joint finance company in China: total assets of more than US \$ 10 billion at the end of the year prior to filing the application. (4) Qualifications for foreign financial institutions to engage in local currency business are as follows: three years business operation in China and being profitable for two consecutive years prior to the application. Arts 10, 12, 11 and 34 of the Regulations respectively.

With these unique characteristics, the operation of finance has many inherent risks including credit risk, market risk and legal risk. The use of internet has also brought to the financial transactions with more systemic risks which include global systemic risks, solvency risks and other risks to the depositors.<sup>31</sup> So far, there is no mechanism in China “to address solvency issues within a financial conglomerate such as double or multiple gearing, risks incurred by unregulated entities, and erection of firewalls between subsidiaries and parent companies.”<sup>32</sup> All these inherent risks together with the possibility of cross-border financial swindling make the payment become more difficult. This will lead to the financial crisis and even become the cause of social turbulence in some countries or areas.<sup>33</sup>

In view of these factors, the World Trade Organization, while promoting the opening of financial sectors within its Members, has recognized the necessity for each Member to take some restrictive measures for prudential reasons. The author of this article considers that the bottom-line implied in GATS is that any measures, which are *de facto* inconsistent with the requirements of national treatment, should be used only for prudential reasons. In the context of the Regulations and Rules, we need to look into whether these prudential reasons have been abused. To be specific, two relevant issues deserve questioning. One is the limits on prudential reasons permitted by GATS and the First Annex. The other is whether the juridical-person-bank orientation is really out of prudential reasons.

## II. Bottom-line of the Prudential Reasons

The text of GATS and other WTO legal documents do not expressly provide the definition of “prudential supervision” or the limits on “prudential reasons”.<sup>34</sup> A report on the review of further liberalization of trade in services published by the WTO Secretariat in 2000 provides that the recognized prudential supervision measures may include rate of capital sufficiency, restrictions on risk overlapping, requirements on risk management systems, management of the circulation of capital, banning of

<sup>31</sup> L. L. C. Lee, ‘The Basle Accords as Soft Law: Strengthening International Banking Supervision’, 39 *Virginia Journal of International Law* (1998) 1, 33-34.

<sup>32</sup> Y.-H. Kim, Financial Opening Under the WTO Agreement in Selected Asian Countries: Progress and Issues (September 2002) available at [http://www.adb.org/Documents/ERD/Working\\_Papers/wp024.pdf](http://www.adb.org/Documents/ERD/Working_Papers/wp024.pdf) (last visited 10 December 2009).

<sup>33</sup> The current global financial crisis is more or less connected with these characteristics.

<sup>34</sup> A. Kern, *The World Trade Organization and Financial Stability – the Need to Resolve the Tension Between Liberalisation and Prudential Regulation* (2002), 23.

internal dealings and dealings leading to conflicts of interest, classification of inefficient assets, test requirements on the competence and qualification of the members of board of directors and managers, requirements on the transparency and information disclosure, etc.<sup>35</sup> The listings in the above report do not include the registration of a juridical-person bank or the minimum level for each transaction. Since the finance capacity of each WTO Member varies, there is no uniform understanding with respect to the specific measures for prudential supervision. GATS allows WTO Members to determine on their own the “prudential reasons” and the relevant measures. This lenient consideration provides WTO Members with a possibility to practice trade protection in the name of prudential supervision.

On making its explanatory statements, the CBRC considers that there are two facts, which we need to keep in mind, while judging whether a specific measure is based on prudential reasons. One is that the purpose of implementing such restrictive measures is to protect the clients, especially the depositors, and to ensure the integrity and stability of the financial system. This may be regarded as the legitimacy in motives. The other is that it is an impractical way to judge the prudential measures of one Member with the criteria of other Members, as there are no uniform criteria, which are applicable to all WTO Members. One measure effective to a Member does not necessarily mean the same to others. The liberalization progress of trade in services should reflect the relevant Member’s economic development levels and its policy orientations. All WTO Members have the right to take prudential supervision measures within the framework of GATS.<sup>36</sup> There is a sound reasoning in the explanations made by the CBRC. The point, however, is that the implementation of prudential supervision measures should satisfy the necessity test requirement in addition to the above two facts.<sup>37</sup> Otherwise, any unnecessary measures might be interpreted as prudential supervision measures.

Necessity testing may be based on mathematic data or empirical research. In the case of the Regulations and Rules, the Chinese authorities

<sup>35</sup> The CBRC, Q&A Regarding the WTO and the Opening-up of the Chinese Banking Sector, Chapter I (Rules), available at <http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=2854> (last visited 16 December 2009).

<sup>36</sup> The CBRC, Q&A Regarding the WTO and the Opening-up of the Chinese Banking Sector, Chapter II (Rights and Obligations), available at <http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=2858> (last visited 16 December 2009).

<sup>37</sup> H. Xiaoyong, ‘The Comparative Study of Market Accession of Foreign Banks and China’s Commitments for WTO Entry’, *International Business Research* (2004), 32-34.



need to provide convincing reasons for the restrictions on foreign bank branches. The abuse of prudential supervision measures will go against the original intention of the drafters. Although the text of GATS does not contain any provisions regarding the definition of necessity, paragraphs (a), (b), (d) and (i) of Article XX of GATS provide the basic elements for it. Therefore, before we determine whether a specific measure falls within the scope of prudential supervision measures, we may first look into the GATT/WTO dispute settlement practices.

In the *Tuna* case, the Panel concluded that the contracting party taking restrictive measures must prove that it had exhausted other reasonable alternative measures available, which were less contravening the GATT rules.<sup>38</sup> In the *Gasoline* case, the Panel excluded those alternative measures, which are impossible to carry out.<sup>39</sup> In the *Asbestos* case, the Appellate Body concluded that it needed to refer to the particular situations when judging whether a measure was out of prudential supervision reasons. Only under the justifications that the alternative measures were effective to achieve the legitimate purpose of the implementing Member, might those among them, which were less contravening the WTO rules, be accepted as the reasonable alternative measures.<sup>40</sup>

The GATT/WTO dispute settlement practice has provided some guidelines in clarifying the prudential supervision measures. Nevertheless, it is the practice achieved in the trade of goods. There is no comparable practice in the trade of services. More importantly, the WTO Dispute Settlement Body does not follow the *stare decisis* doctrine. In other words, no official interpretations concerning the prudential supervision measures exist. In view of this reality, the author of this article believes that the essential elements of prudential supervision measures should at least include the legitimacy in motives and the necessity in practice.

<sup>38</sup> Panel Report, *United States – Restrictions on Imports of Tuna*, 30 I. L. M. 1594, 1991, 155.

<sup>39</sup> See Panel Report, *United States – Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, 29 April 1996, paras 6.26- - 6.28.

<sup>40</sup> See Appellate Body Report, *EC – Measures Affecting Asbestos and Asbestos-containing Products*, WT/DS135/R, 12 March 2001, paras 173-174.

## E. Legal Analysis on China's Prudential Supervision Measures

Before we start any legal analysis on China's prudential supervision measures, it is necessary to clarify the following two issues related to the official statements made by the CBRC.<sup>41</sup>

(a) Pursuant to the provisions of Article XX of GATS, issues concerning (i) whether a Member opens its specific sectors of trade in services, (ii) to what extent a Member will open its sectors, and (iii) which restrictive measures the Member will take, should be specified in its Schedule upon accession into the WTO.<sup>42</sup> Therefore, international practices and customs do not have relevance to the specific commitments made by a WTO Member. To comply with international practices and customs does not necessarily mean compliance with a Member's specific commitments.

(b) Although the Regulations and Rules grant a foreign financial institution the right to determine whether or not to register as a Chinese juridical-person bank, the fact is that the registration is the precondition for a foreign financial institution to fully run its business in China. The foreign bank branches cannot enjoy the same treatment as that the juridical-person banks with foreign fund may have. The Chinese authorities do not provide any convincing data or persuasive reasons for this difference. Following this vein, the author of this article takes the view that the statements made by the CBRC cannot be justified.

### I. Analysis on the Legitimacy in Motives of China's Restrictive Measures

According to the statements of the CBRC, the purpose of setting restrictions on certain businesses of foreign bank branches is to protect the interests of depositors and to ensure the integrity and stability of China's financial system. As foreign bank branches are not Chinese juridical-person enterprises, they are mainly supervised by the authorities of the registering countries or regions. If their parent banks suffer liquidity problems or payment crisis, the Chinese authorities will not be able to prevent foreign bank branches from further risks. As for the juridical-person banks with foreign fund, the Chinese authorities are able to do so by supervising the

<sup>41</sup> Yan & Chun-lin, *supra* note 9.

<sup>42</sup> WTO, *supra* note 1, 301.

flow of capital or freeze assets when a juridical-person bank with foreign fund is bankrupted. Therefore, the prudential supervision measures implemented by the Chinese authorities can be justified with the legitimacy in motives.

## II. Analysis on the Necessity of China's Restrictive Measures

As previously mentioned, the Regulations and Rules have raised the threshold of market access on local currency business for foreign bank branches and banned them from certain modes of services in China. As a matter of fact, these restrictions have the effect to protect the Chinese counterparts from competition and this has been recognized by those foreign bank branches, which responded to our survey. If the Chinese authorities impose these restrictions for prudential supervision reasons, they need further to justify the necessity of these measures in practice.

As a general rule, the Regulations and Rules have provided the following requirements in regard to the operation and supervision for juridical-person banks with foreign fund and foreign bank branches:

- (1) Minimum level of registered capital and operating capital (Article 8 of the Regulations).
- (2) A series of prudential supervision requirements (Article 9 of the Regulations and Article 3 of the Rules).
- (3) The sole shareholder or the shareholder in control of a juridical-person bank with foreign fund must be a commercial bank and the requirement of its minimum total assets (Articles 10 and 11 of the Regulations).
- (4) Capital sufficiency rate requirement (8%) (Articles 10-12 of the Regulations and Article 6 of the Rules).
- (5) Compliance with equity debt ratio requirements provided by the Commercial Banking Law of PRC (Article 40 of the Regulations).
- (6) Reservations for the bad debts requirement (Article 41 of the Regulations).
- (7) Requirement of compliance with the regulations regarding corporate governance and related transactions (Articles 42 and 43 of the Regulations).
- (8) Requirements on the competence and qualifications of senior management personnel of juridical-person banks with foreign fund (Chapter IV of the Rules).

- (9) Supervision and management provisions (Chapter V of the Rules).
- (10) Other prudential supervision provisions set forth in the Regulations, Rules and the Commercial Banking Law of PRC.

In addition to the above requirements, the Regulations and Rules contain the following special provisions for foreign bank branches:

- (1) 30% operating capital of any foreign bank branch should be deposited in the form of interest-producing assets in three or fewer Chinese-funded commercial banks with good records, which are designated by the CBRC (Article 44 of the Regulations and Article 85 of the Rules).
- (2) The proportion of the share of Renminbi in the total amount of operating capital, reservations and other items to the Renminbi risk assets of a foreign bank branch should be no less than 8% (Article 45 of the Regulations).
- (3) Any foreign bank branch should ensure the proportion of the remaining sum of the circulating capital compared with the remaining sum of the circulating debt shall be no less than 25% (Article 46 of the Regulations).
- (4) The remaining sum of the foreign currency and local currency assets of a foreign bank branch should be no less than her remaining sum of foreign currency and local currency debt (Article 47 of the Regulations).

In the *Report on the Opening-up of the Chinese Banking Sector* published in March, 2007, the CBRC further provides that with “respect to foreign bank branches, China has requested under the market entry conditions that the parent bank of foreign-funded banks should guarantee without conditions the liabilities of its branch in China.”<sup>43</sup> Article 17 of the Regulations provides that after the application to open a branch in China has been approved, the parent bank should submit to the CBRC “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

<sup>43</sup> The CBRC, *Report on the Opening-up of the Chinese Banking Sector*, (25 January 2007) available at <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=200703220DEB2435789A50E9FF2A1732C43BBA00> (last visited 16 December 2009)

incur.” In addition, Article 9 of the Regulations specifically provides that the countries or regions where the shareholders of a proposed wholly foreign-owned bank, Sino-foreign joint bank or branch of a foreign bank are located should have perfect financial supervision systems and their financial authorities shall have established good supervisory and regulatory cooperation with the CBRC.<sup>44</sup>

The CBRC may use the above measures, especially the requirements on capital sufficiency rate, loss provision sufficiency rate, wholesale credit extension concentration ratio, cross-border capital flow and deposit payment capability, to isolate the risks from the foreign financial institutions in China. If the routine supervision cannot effectively control these risks, the CBRC may take special or specific inspection and supervision. Based on this analysis, the author of this article concludes that the provisions in the Regulations and Rules are detailed enough and the current prudential supervision measures on foreign bank branches cannot be justified with the necessity test in practice.

Since the foreign bank branches charge more for their service than their Chinese counterparts, their clients will still be limited to those with more assets. On the other hand, the banking card business usually focuses on the daily consumption of clients. Although the consumption by credit card is becoming more and more common in China, the high interest for overdraft (annual interest rate is more than 18%) may hold back the risks to a certain extent. Meanwhile, the users of debit cards must deposit enough money before they use the card. In view of all these factors, it appears that there are no natural links between the ban on foreign bank branches from banking card business and the protection to the depositors and the financial system.

## F. Conclusion

The fact that a WTO Member determines on its own the specific prudential supervision measures does not necessarily mean that such measures can be used to evade its specific commitments. Other WTO

<sup>44</sup> By the end of 2006, China has established bilateral supervisory and regulatory cooperation links with 22 countries and regions which include the United States, Canada, Germany, Korea, Singapore, Hong Kong, Macau, France, Australia and Italy. The contents of cooperation include information sharing, cooperation on the market access and investigation on the spot, confidentiality with respect to the information concerning supervision, consultation on the issues of supervision and regulation. *Id.*

Members may still use the Trade Policy Review Mechanism or even the dispute settlement proceedings to challenge the legitimacy and necessity of these measures. When China is in disagreement with other Members for these restrictive measures on foreign bank branches, the prudential supervision may not be a sufficient and persuasive defense. In other words, these measures are likely to be considered as the violations of WTO rules and the specific commitments made by China.

There is no doubt that China's WTO service commitment represents the most rigorous liberalization in the WTO's history.<sup>45</sup> China has made it clear in Paragraph 308 of the Report of the Working Party on the Accession of China that "upon accession, China would ensure that China's licensing procedures and conditions would not act as barriers to market access and would not be more trade restrictive than necessary."<sup>46</sup> Based on the aforesaid analysis, the author of this article suggests that the State Council of China and the CBRC should reassess the relevant provisions of the Regulations and Rules.

<sup>45</sup> Xuan, *supra* note 26, 23.

<sup>46</sup> WTO, *supra* note 3, para. 308.