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China's New Foreign Bank Regulations

The promulgation of *Regulations for the Administration of Foreign-Funded Banks* on November 11, 2006, marked the beginning of a new chapter for foreign banks in China. Foreign banks can now offer commercial banking services to any customer, regardless of their nationality, everywhere in China. The opening of the Chinese banking market, however, has come with significant conditions. Only those banks that choose to incorporate their operations in China will be allowed to provide a range of services on par with their domestic counterparts. This restriction, coupled with a higher minimum capital commitment, has effectively raised the costs for foreign banks wanting to enter or to expand their operations in China. This ***Asia Focus*** provides a brief summary of foreign banks' experience in China, an overview of the new capital requirements and their impact, and a review of the operational challenges foreign banks will face in complying with the new regulations.

Getting Closer to National Treatment: Fulfilling a Five-Year-Old Promise in Retail Banking

The opening of the Chinese banking market has been a slow and incremental process. The first three decades of the People's Republic of China starting in 1949 were challenging, as several foreign banks saw their operations frozen, nationalized, or severely restricted. By the time the market reopened in 1980, only four institutions had survived: HSBC, Standard Chartered, the Bank of East Asia, and the Overseas Chinese Banking Corporation. The first steps to reopen the market were made when the Chinese government allowed foreign banks to establish representative offices in the early 1980s. Further opening occurred in 1985 with the passage of regulations that allowed foreign banks to engage in limited commercial banking operations in China's Special Economic Zones. During this time, a few American banks re-established their operations in China, including among others Citibank, Bank of America, and American Express Bank. It was not until 1994 that foreign institutions were allowed to transact business through the country, but business had to be booked only in foreign currency. The provision of services in the local currency (renminbi –RMB) was restricted to only a few major cities, and banks could not offer RMB banking services to local residents.

Handicapped by these restrictions, foreign banks in China saw their business stagnate relative to their domestic competitors. At year-end 1998, foreign banks in China had about the same aggregate assets (roughly \$34 billion) as four of the leading joint-stock holding commercial banks (JSCBs), medium-sized lenders founded in the mid-1990s. Over the next seven years these four JSCBs, benefiting from more favorable regulatory treatment, saw an average annual growth rate of 33 percent, significantly higher than the 13 percent that foreign banks in aggregate achieved. By the end of 2005, the four JSCBs had witnessed a more than sevenfold increase in their total assets to \$263 billion, while the foreign banks' aggregate asset base grew to just $79 billion.

Under the terms of its accession in 2001 to the World Trade Organization, China committed to allow foreign banks to offer commercial banking services on an equal basis with Chinese banks within five years. The new regulations met this promise by finally allowing foreign banks to provide RMB-denominated banking services to all customers throughout China. This liberalization, however, came with one significant caveat. While all previous foreign bank regulations made no distinction between a foreign bank branch and a locally incorporated foreign-owned bank, the new regulations treat them differently in three key areas:

- Subsidiary banks are allowed to take RMB-denominated retail deposits, but foreign bank branches can offer Chinese residents only time deposits with account balances of at least RMB 1 million ($130,000). This restriction severely limits the customer reach of foreign bank branches, as the average per capita disposable income of Chinese urban residents in 2006 was RMB 11,759 ($1,500).
- Foreign bank branches cannot provide RMB-denominated loans to Chinese residents, while subsidiary banks can do so.
- Only subsidiary banks can offer bank cards. This restriction blocks foreign bank branches from entering into the expanding and promising consumer credit card market, and prevents these branches from directly offering ATM and credit cards to their foreign and Chinese corporate customers.

Given the growth and revenue potential of the Chinese retail banking market, nearly all of the most active foreign banks have opted to dedicate the time and resources needed to incorporate locally. For banks choosing to incorporate, the regulation requires that all but one of a foreign bank's existing branches in China be converted into branches of the new subsidiary bank; one direct branch for the time being will be allowed to conduct limited foreign-exchange wholesale banking. On March 20, 2007, four foreign banks – HSBC, Standard Chartered, Bank of East Asia, and Citibank – received final approval to open the first foreign-owned subsidiary banks to be formed after the introduction of the new regulations. Another eight foreign banks are in the process of incorporating, and three other institutions' applications are being reviewed. In aggregate, these fifteen institutions accounted for more than half of all foreign bank branches and sub-branches in China as of June 2006.

New Capital Requirements Simplifies Existing System, but Raises the Cost of Entry

Foreign banks have consistently pointed out that their branches were disadvantaged by the higher capital requirements relative to domestic banks. Prior to the new regulation, foreign bank operations were required to comply with a complex schedule of minimum capital requirements. In general the China Banking Regulatory Commission (CBRC) required foreign banks involved in more complex and comprehensive operations to hold more capital. A foreign bank branch could in theory operate under one of six types of licenses based on the currency of their business, the types of customers they were allowed to serve, and the scope of twelve permitted services offered. A similar sliding scale was applied to locally incorporated subsidiary institutions (both wholly-owned and joint-venture banks). Of the three factors used to delineate between the various licenses, the most important was whether a foreign bank could offer RMB services. As of the end of June 2006, roughly half of the foreign bank branches and existing foreign bank subsidiaries had RMB licenses (Table 1).

Table 1

Minimum Capital Requirements Based on Business Scope (In RMB Millions)

Foreign Bank Regulations Scope of Business Currency of Business	Customer Type	Former (2001)*						Current (2006)		
Foreign	Foreign Firms	●	●	●	●	●	●	●	●	●
	Foreign Individuals	●	●	●	●	●	●	●	●	●
	Domestic Firms	◗	●	◗	●	●	●	●	●	●
	Domestic Individuals		●		●	●	●	●	●	●
RMB	Foreign Firms			●	●	●	●		●	●
	Foreign Individuals			●	●	●	●		●	●
	Domestic Firms			◗	◗	●	●		●	●
	Domestic Individuals						●		○	●
Minimum Capital Requirements										
Foreign Bank Branch	Operating Capital	100	200	200	300	300	500	**200**	**300**	**n.a.**
Banking Subsidiary	Paid-in-Capital	300	400	400	500	600	1000	**n.a.**	**n.a.**	**1000**
Subsidiary Branch	Operating Capital	100	100	200	200	200	300	**n.a.**	**n.a.**	**100**

● = Full Service ◗ = Partial Service ○ = Very Limited Service

* Although the 2001 regulation contains 6 types of licenses, while the regulation was in effect no foreign bank received the license that would allow RMB banking with domestic individuals.

The new regulations have significantly reduced foreign banks' licensing options.

- Foreign banks applying to establish new direct branches now have only two licenses from which to choose: 1) offering services denominated only in foreign currency to all customers or 2) offering these same services plus limited RMB services as described above. Banks that used their direct branches primarily to provide multinational corporations with foreign-currency denominated services will now be able to offer foreign-currency services to a wider customer base, but will see the minimum capital requirement double to RMB 200 million ($26 million). On the other hand, branches that offered the fullest permitted range of RMB services prior to the new regulation will now be able to take some retail deposits with no change in their minimum capital requirement of RMB 300 million ($39 million).

- Locally incorporated foreign banks are now treated on par with their domestic counterparts in terms of their paid-in capital and branch operating capital requirements. Setting up a subsidiary bank under the new rules requires at least RMB 1 billion ($130 million) of paid-in-capital. Previously, foreign banks could establish a subsidiary bank with limited operations for as little as RMB 300 million ($39 million); that lower-cost and smaller-scope option is no longer available. On a positive note, branches of foreign subsidiary banks now face lower minimum operating capital requirements: RMB 100 million ($13 million) as compared with RMB 300 million ($39 million), previously.

These capital changes will have a more significant impact on new entrants to the Chinese market than on current participants. Existing direct branches or subsidiary banks will not be forced immediately to raise new capital; however, they will also not be allowed to expand their business scope, change their shareholders, or add new branches until they comply with the new minimums. Direct bank branches with RMB licenses will not be significantly affected by the increased capital requirement as the majority of these branches operate under licenses requiring them to hold capital in excess of RMB 300 million ($39 million). However, for those banks seeking to enter the market now, the capital commitment to establish a branch has increased.

Of the eleven joint-venture or wholly-owned foreign subsidiary banks established before 2007, only one currently has paid-in-capital exceeding RMB 1 billion ($130 million). The other ten banks on average have only RMB 482 million ($63 million) of paid-in-capital; raising new capital will be essential to their ability to take advantage of the liberalizations contained within the new regulations. For the foreign banks establishing new locally incorporated subsidiary banks, the required minimum capital level may increase or decrease after conversion of their branches, depending on the complexity of their operations. Overall, the new rules in terms of their treatment of capital requirements have simplified the schedule of licenses and have raised entry costs for foreign banks in China.

Newly Formed Bank Subsidiaries Face Operational Challenges

The new regulations require foreign-owned banks to comply with the same operational standards that apply to their domestic counterparts, as outlined in the Commercial Banking Law of China:

- The loan-to-deposit ratio must not exceed 75%;
- The assets-to-current liabilities ratio must be at least 25%;
- Total loans to a single borrower must not exceed 10% of the bank's net capital.

Among these mandatory operating ratios, the loan-to-deposit ratio presents a key challenge to foreign banks. Due to the previous geographic and customer restrictions, foreign banks' local currency deposits growth has not kept pace with their loan growth. As of year-end 2006, the aggregate loan-to-deposit ratio of foreign banks in China was an estimated 155 percent. If all the foreign banks locally incorporated their Chinese operations, they would have to attract nearly RMB 337 billion ($44 billion) in new deposits to meet this requirement, or basically double their current level of deposits. Attracting those deposits will be difficult given the small number of outlets that foreign banks currently operate in China. For example, the four foreign banks that recently won approval to incorporate locally had only 25 business offices on average. In contrast the JSCBs, on average each operated 308 business offices.

In response to foreign banks' requests, the CBRC granted them until year-end 2009 to comply fully with the single borrower limits and year-end 2011 to adjust fully to the loan-to-deposit ratio requirement. All other requirements under the new regulation will come into force on August 1, 2007. The foreign banks have accepted this challenge and are gearing up their operations by opening new branches and hiring new staff to meet these requirements.

Conclusion

According to surveys by PriceWaterhouseCoopers published in 2005 and 2007, foreign bank managers who do business in China consistently cited the regulatory environment as one of the main challenges to their operations. The recently adopted changes improve the regulatory environment for foreign banks that are already significant players in China. Some banks can expand their operations in China by offering retail credit and deposit services to local customers. On the whole, however, the cost of operating in China may continue to be too high for all except the largest global international banks.

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