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**China's Entry Into the WTO:
“Implications for Market Access of European Banks in
China and Chinese Banks in the EU”**

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Abstract

- Title:** China's Entry Into the WTO: "Implications for Market Access of European Banks in China and Chinese Banks in the EU"
- Author:** Wang Teng
- Tutors:** Lars Gorton and Jens Forssbaeck
- Purposes:** The aim of this thesis is to analyze the impact of China's entry into the WTO on European banks' market access in China and Chinese banks' market access in the EU.
- Method:** To answer the above question the best way of research is to make a survey from the industry's perspective. In the legal part, I made a broad analysis of banking legislation for market access in the EU and China. In the business part, primary and secondary data are used to study how banks should react under current circumstance.
- Conclusion:** Successful market entry can be achieved either through Greenfield Mode or M&A Mode. European banks adopt both Greenfield Mode and M&A Mode to penetrate into the Chinese financial market. Under Greenfield Mode, European banks should follow European enterprises and seek Chinese premium customers. Product factor should also be considered to find European banks' niche market. Cooperation with local banks will also speed up European banks' market entry process. Except traditional Greenfield Mode, European banks adopt M&A Mode by strategic investment in Chinese banks. This strategy will afford European banks

immediate access to target market, well-established customer base and branch networks of local banks.

At present, Chinese banks penetrate the European financial market through Greenfield Mode. Chinese banks will benefit from brand name recognition and credit rating of the head office by establishing a branch. Establishing a wholly owned subsidiary will afford Chinese banks the benefit of Single Banking License and Universal Banking Model. I also suggest M&A Mode as a long-term strategy to Chinese banks.

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Preface

This paper is a master's thesis for the Master of European Affairs programme at Lund University. This thesis will discuss the implications of China's WTO entry for market access of European banks in China and Chinese banks in Europe.

This paper could not have been completed without my two tutors, Mr. Lars Gorton and Mr. Jens Forssbaeck. They encouraged me to read more and go deeper into the topic. It is my duty to express sincere thanks to them, Thank you.

I also want to say thanks to my family, friends, study mates and all the people I interviewed. Without their help, I could not have finished it. A word of thanks also goes to my friend Ms. Cheng Yang for polishing this paper.

I hope you can get something from reading this paper.

Sincerely,

Wang Teng

Chapter 1

Introduction

1.1 Background

China's entry into the World Trade Organization in December 2001 marked the world's most populous country and the 7th largest economy making a giant leap forward to an open market and free trade principles. From the end of the 1970s, China started to adopt a market economy and began to open its market to foreign goods and investors.¹ Accession to the WTO will require China to further bring its law and practice in line with the international standards.

In China's commitments to WTO entry, China promised to provide increased market access in service sectors including banking, insurance and telecommunication, which are most attractive to EU firms. In the banking sector, China committed to provide full market access and national treatment to foreign banks within 5 years of accession.

After China's entry into the WTO, China lifted restrictions against foreign banks gradually. But some restrictions still exist; the main problems are High Threshold of Entry and Quantitative Restrictions. Table 1.1 illustrates the restriction on activities of foreign banks before and after China's WTO entry.

Banking business together with insurance and securities represent 3.4% of employment and more than 6% of GDP in the EU.² A more liberalized Chinese financial market will improve the business climate for European firms and eventually benefit the EU economy as a whole. China's liberalization of its financial market will

¹ See Dipchand, C. R., Zhang, Y. & Ma, M., (1994), "The Chinese Financial System", Pp.176.

² European Commission, "Summary of The EU's Initial Request To Third Countries In the GATS Negotiation", (1July 2002), http://trade-info.cec.eu.int/doclib/docs/2004/april/tradoc_116821.pdf.

Table 1.1

Restrictions of Foreign Financial Institutions' Activities Before and After China's WTO Entry

	Restriction of Activities Before China's WTO Entry	Restriction of Activities After China's WTO Entry
Foreign Financial Institutions In the Form of: Foreign Bank Branch Joint-Venture Bank Wholly Foreign-owned Bank	<i>Foreign Currency Business:</i> (1) Geographic Restrictions: provide service only in major cities (2) Client Restrictions: provide service to foreign customers <i>Local Currency Business:</i> Restricted. only a few foreign banks are allowed to conduct local currency business in Shanghai and Shenzhen (two financial centers in China) (Details see section 4.5.1)	1. High Threshold of Entry: Excessive high working capital requirements 2. Quatitative Limit Only allow to establish one new branch per year, etc (Details see section 4.5.3)

Source: WTO Ministerial Conference, "Report of the Working Party on the Accession of China" annexed to the Protocol of Accession of China.

benefit her own economy as well. More presence of foreign banks will intensify competition, lower price of financial products and bring more expertise knowledge. China's WTO entry will also provide more opportunities for Chinese banks to compete with foreign counterparts in world market.

1.2 Problems

Historically, the Chinese financial market has been heavily regulated.³ Foreign

³ Godwin, A., (2003), "Foreign Banks in China", in Freshfields Bruckhaus Deringer "Doing Business in China",

bank's market access was strictly controlled. After China's entry into the WTO, China implemented her promises made at the accession. New rules were implemented to lift geographic restrictions and client limitations. Foreign banks are enjoying more and more market opportunities than before. But there are still many outstanding or delayed issues, especially in the area of "banking, auto and intellectual property rights" said EU Trade Commissioner Pascal Lamy. The main problems confronted with European banks in China include the followings:

- Lack of sufficient market access
- Lack of adjusting to international standards and effective implementation of national standards
- Discrimination⁴

China's entry into the WTO will oblige WTO members to accord China permanent Most Favored Nation treatment. The EU has always granting China with MFN treatment before China's entry into the WTO, but restrictions on market access of non-EU banks still exist in some member states; it is still difficult for Chinese banks to penetrate the European financial market.

1.3 Purpose

My main purpose of this thesis is to analyze the impact of China's entry into the WTO on European banks' market access to the Chinese financial market and vice versa. Although China's entry into the WTO and the liberalization of financial market in the EU have significantly improved market access of foreign banks, but due to existence of explicit and implicit rules against foreigners, how to penetrate foreign market efficiently is a crucial question for a bank's growth. This paper will discuss European banks' market entry strategies in China and Chinese banks' market entry strategies in the EU under current circumstance.

Pp.11.10.

⁴ See "Position Paper 2002- 2003" issued by Banking Working Group of European Union Chamber of Commerce in Chin, http://europa.eu.int/comm/enterprise/enterprise_policy/gov_relations/china/f1749h.pdf.

1.4 Methodologies

Subject

China's entry into the WTO implies that China will further liberalize her financial market to the EU countries. It also offers Chinese banks the same opportunity to compete in the EU. But foreign banks still face market access difficulties both in China and the EU. How can European banks penetrate into Chinese market effectively and vice-versa is of much concern both to European banks and Chinese banks.

Having been working in a Chinese bank for many years, the author has a personal interest in this subject.

Approach

The main purpose of this thesis is to give an overview of European banks' market access in China and vice versa after China's WTO entry. I believe that the best way of research is to make a survey from the industry's perspective. In the legal part, I made a broad analysis of banking legislation for market access in the EU and China. In the business part, primary and secondary data are used to study how banks should react under current circumstance.

Data Collection

The data I collected in this thesis encompassed both primary and secondary data. The combination of primary and secondary data provided a good base for the thesis. My research was conducted in two stages.

Initially, I made a preliminary review based on previous literatures, business journals, magazine articles, Chinese law, EU law and WTO rules, which construct my basic concept of banking law and banking business in the EU and China. After collecting the secondary data, I made a comparison and verification of legislation changed before and after China's entry into the WTO both in China and the EU. At this stage, with the help of tutors, the thesis problems, purposes and limitations were

defined and the topic was more focused.

The second stage was conducted through phone interviews and email communications. This primary data was gathered through telephone interviews with European banks' employees in China and vice-versa to reach a preliminary understanding of the impact of China's WTO entry on both European banks and Chinese banks.

In the selection of interviewees, the main criterion was that their opinions must be representative. So among European banks in China, I chose Mr. Marc Poirier (Societe Generale, Beijing), Ms. Hui Dai (Rabobank Beijing) and Ms. Andrea Fiori (Sanpaolo Imi Bank), they are not only employees of European banks, but also members of European Union Chamber of Commerce in China. Therefore, I think their observations have perspective of both their particular banks and the whole industry.

As for Chinese banks in Europe, I managed to interview all three Chinese banks (Industrial and Commercial Bank of China, Bank of China and China Construction Bank) that have commercial offices in Europe. I failed to interview all offices of BOC. But I made a phone interview with Mr. Zhang Baoqiu, who is in charge of overseas branches of BOC. I did the same when interviewing CCB. When I interviewed ICBC, which I have been working for, I was very lucky to interview all three European branches of ICBC.

1.5 Limitations

There are two limitations in this thesis. In the business part, I will focus on commercial banking activities, i.e. acceptance of deposits, lending, trade finance and foreign exchange related business. Investment banking business will be excluded from this thesis. However, the long list of activities annexed to Directive 2000/12/EC⁵ implies Universal Banking Model, which does not distinguish between commercial

⁵ Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions.

banking and investment banking.⁶ Investment banking business might be dealt with only for its relevance to the whole picture of this research.

In the legal part, I will focus on rules governing Greenfield Mode (i.e. setting up new network in foreign market) and suggest future research in regulations on M&A Mode (i.e. acquiring a firm in foreign market). Firstly, foreign acquisition of Chinese financial institutions is a brand new business. The only governing rule was promulgated on Dec 31st, 2003, but this rule did not specify detailed procedures of foreign equity investment in China. Secondly, according to my interview, Chinese banks do not intend to acquire a European bank, at least in the foreseeable future. So I suggest M&A Mode as a long-term strategy to Chinese banks.

1.6 Disposition

This thesis is divided into seven chapters. The introduction gives a general background of the whole paper. It provides the reader with the purpose of the thesis, research problems, thesis methods and limitations.

Chapter two explains market entry theories. This part presents why banks go abroad and adopt different modes of entering into foreign markets. In chapter three, I will discuss basic WTO rules on market access.

I begin chapter four with the historical background and the current situation of the Chinese banking industry. And then, I will talk about Chinese banking law. At the end of this chapter, I will present Chinese rules on foreign banks' market access before and after China's WTO entry. Next is European banks' future market entry strategy in China.

In chapter six, I will study current situation of Chinese banks in Europe, limitations on market access and Chinese banks' future market entry strategy in the EU.

Chapter seven draws conclusions of the research and gives suggestion for future study.

⁶ See Nielsen, P. R., (1994), "Services and Establishment in European Community Banking law", pp.195.

Chapter 2

Theory Framework

What are the motives behind a bank's venture in foreign market? Are they going abroad to grasp new opportunities or to solve their problems or both? What is the most efficient mode of entering foreign market?

In this chapter, firstly, I will explain main determinants of foreign investment by multinational enterprises (MNEs) in general and multinational banks (MNBs) in particular. Then, different foreign market entry modes will be discussed. The main purpose of this chapter is to establish a theoretical framework for the rest of the thesis.

2.1 Eclectic Theory of Determinants of FDI

Dunning's eclectic paradigm⁷ is a dominant framework for examining the decisions of foreign direct investment (FDI) and the activities of multinational enterprises (MNEs). According to Dunning's OLI Paradigm, activities of MNEs are determined by three interrelated factors --- Ownership, Location and Internalization advantages.⁸

Ownership advantages are the advantages specific to the enterprises engaging in FDI and those enable them to be competitive in home market; the basic assumption is that these advantages may be transferred to foreign market to offset extra costs associated with doing business abroad.⁹ So, MNEs must have exclusive access to specific assets, for example technological, managerial, financial and marketing asset, which enable MNEs to produce at low cost. The more competitive the MNEs are, *relative to other firms*, the more they are likely to conduct or increase business abroad.

⁷ Dunning, J.H., (1977), "Trade, location of economic activity and the MNE: a search for an eclectic approach" in Ohlin, B., Hesselborn, P.O. and P.M. Wikman (Eds), *The International Allocation of Economic Activity*, London: Macmillan, pp395-418.

⁸ Dunning, J.H., (2000), "The eclectic paradigm as an envelope for economic and business theories of MNE activity", *International Business Review*, vol 9, pp 163-190.

⁹ Forssback, J., & Oxelheim L., (2004) "Proactive Financial Strategic and the OLI Paradigm of FDI – Evidence from European M&As", discussion paper from *European Integration in Swedish Economic Research*, pp8.

Location advantages are the attractions specific to the host country that make it more attractive for foreign investment. According to Dunning's theory, "*the more immobile, natural or created endowments which firms need to use jointly with their own competitive advantage, favor a presence in a foreign location*", the more likely firms will choose to go abroad.

Internalization advantages are those benefits that enable MNEs to exploit their core capabilities in different economic environments.¹⁰ "*The greater the net benefits of internalizing cross-border intermediate product markets*", the more likely the MNEs are willing to conduct business in foreign market rather than license the right to foreign firms.¹¹

In Dunning's 1989¹² and 1993¹³ articles, further improvement of his theory was made in the area of service sector. According to his theory, a multinational bank must be more comparative than its competitors, these advantages (Ownership Advantages) include economies of scale and specification, brand name recognition from the customers, expertise knowledge, access to international customer and international financial market and the abilities to control cross-border data.

Before MNEs entering into foreign market, they will seek the most favorable location (Location Advantages), which may enable them to maximize their profits, to settle down. Location Advantages include government regulations and cost of foreign firms' entry and operation. Deregulation and liberalization of financial sector in host country, which will remove or lower entry barriers against foreign banks and reduce operation costs, will induce more foreign banks' entry into the host country.

Foreign banks expansion in international market is based on internalization advantages rather than doing business at arms length because it is still difficult to find adequate market information without physical presence in foreign market. So foreign

¹⁰ Kogut, B., (1985) "Designing Global Strategies: Profit From Operational Flexibility", Sloan Management Review, Vol 27 (1), pp 27-38.

¹¹ Dunning, J. H., (2000).

¹² Dunning, J. H., (1989), "Multinational Enterprises and the Growth of Services: Some Conceptual and Theoretical Issues", The Service Industries Journal, Vol. 9, Iss. 1; p. 5-39.

¹³ Dunning, J. H., (1993), "The Globalization of Business: The Challenge of the 1990s", The Economic Journal, vol: 104 issue: 427 pages: 1472.

direct investment in banking sector is an important feature of this industry.

2.2 Determinants of FDI in Banking Sector

Previous literature suggests various determinants of MNBs' investment in foreign country. According to OLI Paradigm, these factors include the following:

Ownership Advantages:

1. Size and capital base of MNBs, According to Cho¹⁴ and Ursacki & Vertinsky¹⁵, banks size has a significant impact on its involvements in foreign market. The larger the banks' size, the more likely they will conduct business in foreign country.

2. Diversification of banking networks. Ursacki and Vertinsky's¹⁶ research suggests that one of the most important variables of MNBs' involvements in foreign market is geographical diversification of banking networks.

3. Knowledge in multinational operations and creditworthiness of MNBs. Cho¹⁷ argued that more knowledge in multinational operations and high creditworthiness of MNBs will stimulate its expansion in international market.

In Cho's article, more specific Ownership Advantages are presented, for example MNBs' access to skilled personnel and differentiated financial products.

Location Advantages:

1. Local banking opportunity

Goldberg and Grosse's¹⁸ study of determinants of foreign banks' activities in the US shows that local banking opportunity is an important factors determining foreign

¹⁴ Cho, K.R., (1986), "Determinants of International Banks", *Management International Review*, Vol 26, Issue 1, pp 10-24.

¹⁵ Ursacki, T., & Vertinsky, I., (1992), "Choice of Entry Timing and Scale by Foreign Banks in Japan and Korea", *Journal of Banking and Finance*, Vol 16, Issue 2, pp 405-422.

¹⁶ Ibid.

¹⁷ Cho, K.R., (1986).

¹⁸ Goldberg, L. G., & Grosse, R., (1994), "Location Choice of Foreign Banks in the United States", *Journal of Economics and business*, Vol 46, issue 5, pp 367-380.

bank growth". Yamori's¹⁹ research of worldwide location choice of Japanese banks shows that determinants of Japanese banks' location choice are based on local banking opportunity in the host country, at least partly. The more business opportunities a country can provide, the more likely foreign banks are willing to invest in the host country.

2. The degree of Regulation on banking activities in host country

As suggested by Molyneux,²⁰ Government's economic and financial policy will be a major motive for foreign inward investment. The introduction of Free Movement of Capital, Single Market and the EMU has significantly reduced or eliminated trade barriers between EU member states and encouraged foreign banks' entry into European market. China's entry into the WTO will also provide more market opportunity to foreign banks.

3. Presence in International Financial Market

According to Molyneux,²¹ the leading banks' presence in certain financial market will encourage others to copy their strategies. This strategy will well explain why most Chinese banks' foreign networks locate in world financial center, such as New York, London, Frankfurt, Hong Kong.

Internalization Advantages

According to Yamori²², the main determinant of Japanese banks location choice is the demand of the Japanese manufacturing sector for Japanese financial institutions. This finding suggests the "Follow the Customer Strategy", MNEs' FDI in host country will encourage MNBs to follow suit. First, home country banks have knowledge advantages that they have already possessed about their customers.²³ Second, after long-term business cooperation between firms and banks of same

¹⁹ Yamori, N., (1998), "A Note on the Location Choice of Multinational Banks: The Case of Japanese Financial Institutions", *Journal of Banking and Finance*, Vol 22, pp 109-120.

²⁰ Molyneux, P., (2004) "Determinants of Cross-Border Mergers in European Banking", in Oxelheim, L., & Ghauri, P., "European Union and the Race for Foreign Direct Investment in Europe".

²¹ Ibid.

²² Yamori, N., (1998).

²³ See Ball, C. A. & Tschogl, A.E., (1982), "The decision to establish a foreign bank or branch or subsidiary: An application of binary classification procedures", PP411-425.

country, home country banks can offer tailor made services that cannot be easily copied by host country banks.²⁴

Molyneux also suggested “Customer Seeking Strategy”, according to this strategy; banks usually chase new customers through M&A activities. Two reasons explain why banks seek new customers through M&A. Firstly, providing financial service without physical establishment is difficult. Secondly, bidder banks will have the well-established customer base of the target bank through M&A activities.²⁵

As suggested by Hondroyiannis & Papapetrou,²⁶ Bilateral trade between host and home country is an important determinant of MNBs’ growth. Growth of bilateral trade implies currency conversion between different countries, foreign exchange settlement and trade finance. Without banks’ involvement, it is difficult or impossible to conduct all these businesses. So, growth of trade volume will require more bank activities between different countries.

2.3 Foreign Market Entry Modes

Previous research discovered that multinational enterprises’ entry into foreign market could be achieved through the following modes:²⁷

- Greenfield Mode, through establishing a new network in foreign country,
- M&A Mode, through merger or acquisition of local firms.

Greenfield Mode could be categorized into two subgroups: sole venture and joint venture. Sole venture implies 100 percent ownership by the parent company, While Joint Venture is a company jointly owned with local firms.²⁸ M&A Mode suggests market entry through acquisition of firms in host country.

²⁴ Ibid.

²⁵ See Molyneux, P., (2004), pp.12.

²⁶ Hondroyiannis, G., & Papapetrou, E., (1996), “International Banking Activities in Greece: The Recent Experience.”, *Journal of Economics and Business*, Vol 48, Issue 3, pp 207-215.

²⁷ See Holger, G., (2000), “Analyzing Foreign Market Entry: The Choice Between Greenfield Investment and Acquisition”, *Journal of Economic Studies*, Vol. 27, NO. 3., pp165-181.

²⁸ See Haeri, M, F. , (1990), “Foreign Market Entry Strategy, behavior of Swedish Companies in the Middle East”, pp9.

2.4 Comparison Between Different Entry Modes

As discussed in section 2.4, multinational enterprises enter into foreign market may take the form of Greenfield Mode or M&A Mode. This section will make a comparison between different modes.

In the banking sector, physical penetration into foreign market could take the form of branch or wholly owned subsidiary (sole venture), joint venture bank (joint venture) or M&A with local banks.

A foreign bank branch is a legal dependent part of a credit institution incorporated in foreign country.²⁹ While a subsidiary is a legal entity, independent from its parent firm, incorporated in the hosting country.³⁰ Establishing a branch or wholly owned subsidiary, the parent company may “devise and execute what it feels is the best marketing strategy for penetrating the foreign market”.³¹ A bank branch could also benefit from bank name recognition and credit rating of the head office. Disadvantages of establishing branch or wholly owned subsidiary are also obvious. This mode is very expensive and time-consuming; large amount of money will be invested to build up branch networks; it is also difficult to get access to biased customers.³²

Establishing joint venture bank in foreign market will provide foreign banks with “local market knowledge, a local identity and shared risk”.³³ With the help of local bank, it will be much easier for banks to enter foreign market. Disadvantage of joint venture banks is lack control because of shared equity with local banks.

Previous literature suggested that the main motive for cross-border M&A is to eliminate trade barrier.³⁴ After acquisition of local bank, Bidder bank will have immediate access to target market, along with a well-established customer base and branch networks of target bank. Acquisition will provide bidder bank with more

²⁹ See Nielsen, P. R., (1994), pp144.

³⁰ See Nielsen, P. R., (1994), pp224 and Articles 1 and 2 of Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts.

³¹ See Haeri, M, F., (1990), pp9.

³² See Dixon, R., (1991), “Banking in Europe: The Single Market”, pp84.

³³ See Haeri, M, F., (1990), pp9.

³⁴ See Molyneux, (2004),pp10.

knowledge about the characteristics of local market, the risk of unsuccessful Greenfield Mode will be avoided. There are also some disadvantages associated with cross border M&As, government control will make cross border difficult, cultural difference and employee resistance could abort the new institution.³⁵

2.5 Summary

Previous literature suggests various determinants of foreign investment by multinational banks; OLI Paradigm has remained the prevalent framework for examining the decisions of foreign direct investment (FDI) and the activities of multinational enterprises (MNEs). According to OLI Paradigm, a bank must possess Ownership, Location and Internalization advantages to make it more competitive than local banks.

Entering into foreign market could be achieved through various modes, careful selection of market entry modes is of much concern to MNBs' success.

³⁵ See Dixon, R (1991), pp85

Chapter 3

Basic WTO Rules

The EU, its member states and China are all members of the WTO. A good knowledge of WTO rules on market access will help understanding this thesis. This chapter intends to give a general picture of relevant WTO rules.

As the only global organization dealing with trade between nations, the goal of the WTO is to facilitate trade between member countries. According to Annex on Financial Services to the GATS (General Agreements on Trade in Services), financial services are divided in to two groups:

- Insurance and insurance-related services,
- Banking and other financial services (excluding insurance).

The second group is divided into two sub-groups: banking and securities. This thesis will focus on banking business excluding securities.

3.1. Definition of Banking Business

According to GATS, banking services comprise “deposits-taking, lending, financial leasing, payment and money transmission services, guarantees and commitments, foreign exchange, trade for own account or for account of customers in money market instruments, exchange and interest rate instruments, money broking, asset management, advisory and other auxiliary financial services”³⁶

3.2 Modes of Provision of Banking Services in International Market

The GATS defines provision of service as consist of four forms:³⁷

- Mode 1 *cross-border supply of service*, where the foreign service providers supply service across the border;

³⁶ See Annex on Financial Services to GATS (GATT Document, MTN/FA, 15 DEC 1993)

³⁷ Article 1.3 of GATS, http://www.wto.org/english/tratop_e/serv_e/cbt_course_e/c1s3p1_e.htm

- Mode 2 *consumption abroad*, where the consumers accept service in foreign country;
- Mode 3 *commercial presence*, where the service is provided through physical establishing branch or subsidiary in foreign country;
- Mode 4 *presence of natural person*, where financial service providers or their employees travel to provide service in foreign country.

Mode 3 is the most popular form of providing banking service by European banks in China and Chinese banks in Europe, so this thesis will focus on Mode 3.

3.3 Basic Rules of the WTO

Most Favored Nation Treatment

Article II: 1 of GATS requires the WTO member countries to treat financial service providers from any other member country (Country A) in the same way as providers from any other country (Country B). MFN treatment excludes preferential treatment to specific members or reciprocal provisions.

The MFN obligation is subject to exemptions. The EU and China are also under the protection of MFN exemptions. In term of financial service, the EU only gives preferential treatment to non-life insurance undertakings whose head offices are situated in Switzerland, while China is not under exemption protection in financial service sector.³⁸ So MFN exemption is irrelevant in this thesis.

Transparency

Transparency is another basic principle of the GATS. According to Article III of GATS, member countries are required to make available to WTO members, upon request, all laws, regulations and other measures pertaining to or affecting trade in goods, service before such measures are implemented or enforced. This principle is to ensure reasonable time for public comment before measures are implemented.

³⁸ See EU MFN exemptions list, WTO GATS/E1/31 94; China MFN exemptions list. WTO GATS/E1/135, http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm

Market Access

As stipulated in Article XVI of GATS, market access regarding provision of financial service requires member countries to eliminate national measures that restrict/prohibit the supply of financial services by foreign suppliers. The followings are some examples of restrictive national measures:

- *Nationality Requirements*, where foreign financial service providers are prohibited or restricted to provide financial services via licenses or authorizations. Other measures include limitations on setting up permanent establishment by foreign providers, restrictions on foreign providers' movement in host country.

- *Residency Requirements*, where foreign financial service providers are required to be a periodical or permanent resident or have a commercial presence in host country.

- *Operational Requirements*, where foreign financial service providers are prohibited or restricted to provide certain financial services.

National Treatment

In accordance with Article XVII of GATS, National Treatment requires WTO members to treat foreign financial services providers the same way as domestic providers, i.e. no discrimination. Discrimination is further categorized into two groups: *de jure* discrimination and *de facto* discrimination.

1) *de jure Discrimination* means overt discrimination against foreigners based upon their nationality, the most common examples of discrimination in law comprise:

- More difficult or costly procedures with respect to licensing and authorizations;
- More difficult or costly conditions of operation;
- High tax burden or restricted access to tax credits
- Higher capital requirements
- Restrictions on the number of foreign financial service providers;

2) *de facto Discrimination* suggests covert discrimination against foreigners, major examples of covert discriminations include:

- Capital requirements that duplicate home country capital requirements;
- Requirements of particular business form in the host country;

Identical rules equally applied to both domestic and foreign financial service providers do not necessarily mean identical treatments to foreigners. One obvious example is capital requirements for foreign bank branches; this measure will force foreign banks that have already met capital requirements in home country to duplicate its capital in host country.³⁹

National treatment, MFN treatment, transparent legal system together with effective market access will facilitate international trade, promote free competition, lower the price and eventually stimulate economic growth.

³⁹ See Raworth, P., (2003) “ The Regulation of Trade in Financial Services Under the General Agreement on Trade in Services”, pp.1-2.

Chapter 4

The Chinese Banking Industry

In this chapter, I will give a general introduction to the Chinese financial market as a base for the following chapters. In sections 1, a historical background of the Chinese financial market will be given. Section 2 will discuss current situation of the Chinese banking industry. Section 3 will talk about Chinese banking regulations on domestic banks. Section 4 will deal with Chinese banking regulations on foreign banks. Section 5 will talk about limitations on Greenfield Mode in China. Section 6 will discuss requirements of M&A Mode.

4.1 Historical Background

Before 1979, the Chinese banking sector adopted monobanking system dominated by the People Bank of China (PBOC). The People Bank of China functioned both as central bank and as commercial bank. Under planned economy, monobanking system is just “*a distributor of funds according to plan and a watchdog supervising the spending of those funds*”.⁴⁰

In 1979, three state-owned specialized banks were established, Bank of China (BOC) was responsible of foreign exchange business; Agricultural Bank of China (ABC) was in charge of agricultural finance; People’s Construction Bank of China (PCBC) provided loans to capital construction.

In 1984, the People Bank of China was designated the central bank and devolved its commercial business to Industrial and Commercial Bank of China (ICBC, China’s fourth state owned specialized bank established on Jan 1,1984).

In 1985, restrictions on designated business sector of four specialized banks were lifted, they were allowed to expand and compete with each other. During the mid 80s

⁴⁰Dipchand, C. R., Zhang, Y. & Ma, M, (1994), pp20

and 90s, competition was very limited because specialized banks still undertook some policy lending activities.

In 1994, three policy banks (*China Development Bank, Import-Export Bank and Agricultural Development Bank of China*) were established by the central government. They are responsible for policy lending on infrastructure, basic industry, export of capital goods and agricultural credit business.

After the mid 80s, 13 shareholding commercial banks were established,⁴¹ 2 of them were either closed or acquired by other banks.⁴² The shareholding commercial banks are owned by governments at different level and Chinese investors.⁴³

Since the mid 90s, some Urban Credit Cooperatives were established by local governments, from late the 90s, some Urban Credit Cooperatives transformed to City Commercial Banks.

In December 1979, foreign banks were allowed to establish representative offices in China. In 1984, foreign banks were authorized to establish commercial offices in Shanghai.⁴⁴

4.2 Current Situation

After twenty years of development, the Chinese banking landscape changed dramatically. This section will talk about current situation of the Chinese banking industry.

Segmented Operation Model

Before 1993, Chinese banking system adopted a mixed operation mode in which commercial banks were allowed to conduct investment and security business.

⁴¹ These banks comprise Bank of Communication, Guangdong Development Bank, Shenzhen Development Bank, China Merchant Bank, Industrial Bank, China Everbright Bank, China Minsheng Bank, Huaxia Bank, Shanghai Pudong Development Bank, CITIC Industrial BANK, Yantai Housing Bank, Hainan Development Bank (closed by People bank of China in 1998) and China Investment Bank (acquired by China Everbright Bank in 1999)

⁴² See Wong, Y., C., Richard & Wong, M., L., Sonia (2001), "Competition In China's Domestic Banking Industry", Cato Journal, Vol 21, No.1., pp19-41.

⁴³ See Dipchand, C. R., Zhang, Y. & Ma, M., (1994), pp74-94.

⁴⁴ See Ibid, pp178.

Commercial banks' imprudent investment in the Chinese stock market was accused of the trigger to stock market shock in 1992. In 1995, the Law of the People's Republic of China on Commercial Banks stipulated that commercial banks can't engage in "trust investment or share business, or invest in immovable property which is not for their own use."⁴⁵ After 1995, the Chinese financial market was distinctly segmented into commercial banking market, security market and investment market. The Segmented Operation Model, which seriously limits Chinese banks' ability to expand, remains up to now.

Governing Bodies

At present, three governing bodies are in charge of bank business. *The People's Bank of China (PBOC)*, the central bank, is responsible for formulating monetary policy and foreign exchange policy. *The China Banking Regulatory Commission (CBRC)*, established in 2003, is in charge of formulation and interpretation of banking rules; examination, authorization and supervision of bank business.⁴⁶ *State Administration of Foreign Exchange (SAFE)* undertakes the role of implementing foreign exchange policy.

All of the above three institutions have branches at provincial and municipal levels. At provincial level, these governing bodies have rights to issue operational guidelines according to local conditions. These guidelines play "a significant role in clarifying and supplementing regulation".⁴⁷ They could make the original regulations different from province to province; sometimes the difference is rather huge. This would render foreign banks' market access different only because of their geographic location.

At municipal level, these governing bodies are responsible for the implementation of national and provincial measures. To some extent, municipal institutions play more important roles than national and provincial government institutions because they will

⁴⁵ See Article 43 of "The Law of the People's Republic of China on Commercial Banks" adopted by the National People's Congress on May 10, 1995.

⁴⁶ <http://www.cbrc.gov.cn/english/yinjianhuijianjie/>

⁴⁷ See Godwin, A., (2003), Pp 11.10.

decide to what extent foreign banks can enjoy the rights conferred by the laws and regulations.

Other Players

Four *state-owned commercial banks* (the Big Four) are still pillars of the Chinese banking industry, in 2000 they accounted for 60.21% of loans and 65.08% of deposits in all financial institutions in China.⁴⁸ Table 4.1 shows that four state-owned commercial banks are large in size, but poor in asset quality. Chinese government established four asset management companies to dispose non-performing loans of four state-owned commercial banks. At the end 2003, four asset management companies accepted non-performing loans, which reaches about 168 billion US Dollars.⁴⁹ All the above factors are the main strength of Chinese banks (Ownership Advantages).

Compared with four state-owned commercial banks, shareholding commercial banks are small in size, but they are healthier in asset quality (See Table 4.1). Their branch networks concentrate in major industrial and commercial cities. At present, three out of ten shareholding commercial banks are publicly listed on Chinese Stock Exchange. They are Shanghai Pudong Development Bank, Shenzhen Development Bank and China Minsheng Bank.

At present, there are about 90 City Commercial Banks all over the country. They are only allowed to conduct business in the city where it's registered. This has proved to be a great handicap to expand their business.

At the end of 2002, there were 155 foreign bank branches and 14 subsidiaries or joint-venture banks in China. European banks had 54 branches in China (35% of the total foreign branches in China).

The fast growth of shareholding commercial banks, city commercial banks and foreign banks has intensified competition in the Chinese financial market. An efficient market entry strategy will be more important to foreign banks.

⁴⁸ Jointly calculated by author with studymate based on the data obtained from the website of the PBOC <http://www.pbc.gov.cn/baogaoyutongjishuju/2002S0.htm> (April.26, 2004) and the annual reports of the four state-owned banks

⁴⁹ Figures come from official website of four asset management companies. <http://www.chamc.com.cn/>, <http://www.gwamcc.com/>, <http://www.cinda.com.cn/>, <http://www.coamc.com.cn/>.

4.3 General Rules on Domestic Banks

The Law of the People's Republic of China on Commercial Banks, adopted by the People Congress on May 10, 1995, is the most fundamental set of rules governing both domestic and foreign banks. It defines major rights and liabilities of commercial banks.

According to this law, commercial banks' main business scopes include deposits, loans, inter-bank loans, settlement, bankcards, safe deposit boxes, sale and purchase of government bonds and other business operations as approved by the central bank.⁵⁰

In China, threshold of entry into financial market is very high. For example, to establish a commercial bank, the applicant must own minimum amount of registered capital of 1 billion RMB (about 125 million USD).⁵¹

4.4 General Rules on Foreign Banks

In China, Foreign banks are subject to double legislation i.e. general rules applicable to domestic banks and foreign banks; rules specialized for foreign banks. Except the general rule, the *Law of the People's Republic of China on Commercial Banks*, *Operational Guidelines of Foreign Financial Institution in People Republic of China*⁵² are specific for foreign banks and defines foreign banks' form, establishment and business scope.

⁵⁰ See Article 3 of "the Law of the People's Republic of China on Commercial Banks" adopted by the National Congress on May 10,1995.

⁵¹ See Ibid Article 13, the minimum amount of registered capital required for establishing an urban cooperative commercial bank shall be RMB 100 million (about 12.5 million USD), and the minimum amount of registered capital required for establishing a rural cooperative commercial bank shall be RMB 50 (about 6 million USD) million . Registered Capital shall be paid-up capital.

⁵² "The Law of the People's Republic of China on Commercial Banks ", adopted by the National Congress on May 10,1995, has no specific rule concerning foreign banks. This operational guideline, promulgated in Feb 7,2002 by the PBOC, specifies foreign banks' rights and obligations.

Table 4.1

Major Chinese Bank's Asset Quality and Total Asset

		Name of the Bank	Total Asset 2003(BL USD)	Non-Performing Loan Rate*			Net NPL/ Equity
				2002	2001	2000	
State Owned Commercial Bank		Bank of China	435	23.7	27.5	27.2	135
		Industrial and Commercial Bank of China	642	25.8	29.8	34.4	420
		China Construction Bank	373	15.3	19.4	20.3	225
		Agricultural Bank of China	360	36.6	42.1	N/A	500
Shareholding Commercial Bank	Non Public	Bank of Communications	93	18.6	16.5	18.3	157
		China Everbright Bank	40	13.3	20.5	28.8	95
	Listed Banks	CITIC Industrial Bank	40	10.35	13.73	N/A	214
		China Merchant Bank	45	8.1	11.87	16.59	57.7
		Huaxia Bank	30	4.79	6.59	7	63
		Industrial Bank of China	31	N/A	N/A	N/A	N/A
		Guangdong Development Bank	36	N/A	N/A	N/A	N/A
	Public Listed Banks	Shenzhen Development Bank	21	8.9	11.7	19.8	163
		Shanghai Pudong Development Bank	21	3.5	8.6	13.2	12
		China Minsheng Bank	43	2.4	4.3	6	6

Source: Official websites of above banks⁵³

* Five tiers loan classification system

⁵³ Bank of China <http://www.bank-of-china.com/english/index.shtml>, visited on April 21,2004
Industrial and Commercial Bank of China, http://www.icbc.com.cn/e_index.jsp,
visited on April 21,2004
China Construction Bank, <http://www.ccb.cn/portal/en/home/index.jsp>, visited on April 21,2004
Agricultural Bank of China, <http://www.abchina.com/abcon/pages/index.html>,
visited on April 21,2004
Bank of Communications, <http://www.bankcomm.com/>, visited on April 21,2004
China Everbright Bank, <http://www.cebbank.com/>, visited on April 21,2004
Shanghai Pudong Development Bank, <http://www.spdb.com.cn/chpage/c1/>,
visited on April 26,2004
China Minsheng Bank, <http://www.haodx.com/url/3985.htm>, visited on April 26,2004
Shenzhen Development Bank, <http://www.sdb.com.cn/>, visited on April 26,2004
China Merchant Bank, <http://www.cmbchina.com/>, visited on April 26,2004
Huaxia Bank, <http://www.hxb.com.cn/index1.htm>, visited on April 26,2004
Industrial Bank of China, <http://www.999abc.com/WebSite6787.htm>, visited on April 26,2004
Guangdong Development Bank, <http://ebank.gdb.com.cn/comminfo/index.jsp>,
visited on April 26,2004
CITIC Industrial Bank, <http://202.108.253.133/citicib/>, visited on April 26,2004.

According to Article 3 of the Operational Guidelines, foreign banks may take three business forms, namely branch, wholly owned bank or joint-venture bank.⁵⁴ At present, foreign bank branch establishment is the most typical business form of foreign banks in China. A *Joint-venture bank* is a legal entity with both foreign and domestic investments. Foreign investments should be no less than 25%,⁵⁵ otherwise it will be regarded as a domestic bank with foreign investment. A *Foreign Wholly-Owned Bank* is a foreign subsidiary with 100 percent foreign investments.

4.5 Limitations on Foreign Banks' Market Access (Greenfield Mode)

4.5.1 Limitations Before China's WTO Entry

Before China's accession to the WTO, foreign banks were only allowed to conduct foreign exchange related business to foreign customers in major cities.⁵⁶ Their business scope comprises foreign exchange related deposits, lending, trade finance, remittance, etc. This implied that foreign banks were completely excluded from local currency business, i.e. Renminbi (RMB) business market. After 1996, some foreign banks were allowed to conduct RMB business to Chinese enterprises in Shanghai and Shenzhen on a trial basis.⁵⁷ Even in these two cities, foreign banks were not allowed to conduct local currency business to individual Chinese customers.⁵⁸

⁵⁴ The original rule: Foreign legal entity includes wholly owned bank, joint-venture bank and foreign bank branch. (My translation)

⁵⁵ See Article 9 of "Regulations on Foreign Equity Investment in Chinese Financial Institutions" adopted by CBRC on Dec 31, 2003, the original rule: Chinese financial institutions with more than 25% of foreign investment will be regarded as foreign financial institutions. (My translation)

⁵⁶ See Article 17 of "Administrative Rules of Foreign Financial Institution in People Republic of China" adopted by State Council on April, 1 1994, the original rule: foreign banks, foreign bank branches and joint-venture banks may conduct the following business under the approval of People's Bank of China: foreign exchange deposit; foreign exchange loan; discount of foreign exchange bills; foreign exchange remittance; foreign exchange guarantee; international settlement; other business approved by the PBOC (My translation).

⁵⁷ See Article 10 of "Shanghai Pudong Administration of Trial Operation of RMB Business by Foreign-Invested Financial Institutions Tentative Procedures" adopted by Shanghai Municipal People's Congress on Dec 2, 1996; Article 14 of "Shenzhen Trial Operation of RMB Business by Foreign-Invested Financial Institutions Guiding Principles" adopted by Shenzhen Municipal People's Congress on Aug 13, 1998.

⁵⁸ Ibid.

Geographic controls and client limitations seriously hampered European banks' growth in China. These restrictions also implied that foreign banks should still focus on foreign currency related businesses and foreign customers.

4.5.2 China's WTO Accession Commitments in the Banking Sector

In China's WTO accession commitments, China pledged to phase out all geographic and client limitations within five years after accession.

Upon accession, for *foreign currency business*, there will be no geographic and client restrictions. Foreign banks are free to conduct foreign currency business with any customers at any place within Chinese territory.

For *local currency business*, geographic limits will be phased out within five years after accession;⁵⁹ client limitations on Chinese enterprises will be lifted within 2 years after accession, client limitations on Chinese individuals will be lifted within 5 years after accession.

4.5.3 Limitations after China's WTO Entry

Upon China's entry into the WTO, China speeded up its pace to open the banking sector by eliminating limitations on foreign currency business conducted by foreign banks. Limitations on RMB business were removed as scheduled, and foreign banks were allowed to conduct RMB business in 13 cities at the end of 2003 compared with 2 cities before China's accession.⁶⁰

⁵⁹ For local currency business, the geographic restriction will be phased out as follows:

- upon accession, Shanghai, Shenzhen, Tianjin and Dalian;
- within one year after accession, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan;
- within two years after accession, Jinan, Fuzhou, Chengdu and Chongqing;
- within three years after accession, Kunming, Beijing and Xiamen;
- within four years after accession, Shantou, Ningbo, Shenyang and Xi'an.
- within five years after accession, all geographic restrictions will be removed.

⁶⁰ <http://www.cbrc.gov.cn/>

But problems still exist, especially in respect of authorization requirements and business scope limits. The following section will talk about the main problems confronted with foreign banks after China's WTO entry.

High Threshold of Entry

Working capital requirements for establishing a foreign bank branch range from 12million Euro to 72 million Euros. Excessive requirements of working capital will seriously tie up foreign banks' capital and damage their competitiveness. These requirements are far beyond the scope of prudential supervision and should be amended to be in line with international standards.

Quantitative Restrictions

1) Foreign banks are only allowed to open one new branch per year.⁶¹ This apparent quantitative restriction on foreign banks can only limit foreign banks' expansion.

2) Basically, Chinese companies are only allowed to open one foreign currency account in the bank.⁶² This limit has no direct negative impact on foreign banks. But in practice such an account is always maintained with a local bank where Chinese companies are incorporated because cross-city opening foreign currency account is subject to local authority's approval. Local authority is *"very protective in executing registration and approval processes, making it effectively impossible for a company in their area to shift banking business to a foreign bank that is registered outside their area"*.⁶³ Consequently, this policy limits foreign banks' opportunity for conducting foreign currency business with Chinese companies. All the above

⁶¹ Article 14 of "Operational Guidelines for Foreign Financial Institution in People Republic of China" adopted by the PBOC on Feb 7, 2002, the original rule: Foreign banks' application for establishing new branch shall be made one year after the approval of the previous branch (My translation).

⁶² Article 7 of "Operational Guidelines of Foreign Current Account of Domestic Enterprises" adopted by the SAFE on Mar 27, 2003, the original rule: Opening of current account by Chinese institutions in different banks is subject to the approval of the PBOC.

⁶³ See "Position Paper 2002-2003" issued by Banking Working Group of European Union Chamber of Commerce in China, 2003. http://europa.eu.int/comm/enterprise/enterprise_policy/gov_relations/china/f1749h.pdf.

quantitative restrictions are contrary to WTO rules, which require member countries to eliminate *de jure* discrimination against foreigners.

In summary, some of the above measures amount to direct or indirect discrimination against foreigners; some are obvious violation of China's WTO entry commitments. All these measures should be brought in line with WTO rules and China's WTO entry commitments.

4.6 Limitations on Foreign Banks' Market Access (M&A Mode)

Before 2003, foreign financial institutions were actually forbidden to invest in Chinese financial institutions according to "*Regulations on Investment in Chinese Financial Institutions*".⁶⁴ Despite this prohibition, the People's Bank of China approved several foreign equity investments in Chinese banks on a case-by-case basis (see Table 4.2).

On Dec 31st, 2003, "*Regulations on Foreign Equity Investment in Chinese Financial Institutions*" (hereinafter called FEI Regulation) was promulgated by the Chinese Banking Regulatory Commission, to which the People's Bank of China ceded the responsibility to authorize and supervise the banking business. This regulation set a legal framework for foreign equity investment in Chinese banks.

According to Article 2 of FEI Regulation, the following foreign institutions are allowed to invest in Chinese financial institutions: financial companies incorporated in foreign countries, foreign commercial banks, foreign insurance companies, foreign security companies and other foreign financial institutions approved by the CBRC.⁶⁵ In accordance with the same article a wide range of Chinese financial institutions are allowed to accept foreign equity investment, this list includes Chinese commercial banks, urban credit cooperatives, rural credit cooperatives, trust investment

⁶⁴ See Article 12 of "Regulation on Investment in Chinese Financial Institutions" adopted by the People's Bank of China on Sep 21st, 1994, the original rule: foreign financial institutions, joint-venture financial institutions and foreign enterprises are not allowed to invest in Chinese financial institutions (My translation).

⁶⁵ The original rule: foreign financial institutions include financial companies incorporated in foreign countries, commercial banks, security companies, insurance companies and other financial institutions approved by the CBRC (My translation).

Table 4.2**Foreign Equity Investmentt in China's Banks**

Chinese bank	Foreign investor	Pct of shares	Time
Bank of Shanghai	HSBC	8%	2001
	Shanghai Commercial Bank (HK)	3%	2001
	International Finance Corp	7%	2001
Nanjing Commercial Bank	International Finance Corp	15%	2001
Shenzhen Development Bank	New Bridge Capital Inc.	18%	2002
Shanghai Pudong Development Bank	CITI Group	5%	2003
China Minsheng Bank	International Finance Corp	1%	2003
	Hang Seng Bank	8%	2003
Xian City Commercial Bank	International Finance Corp	12%	2002
	Scotiabank	12%	

Source: The China Business Review July-August 2003

companies, financial companies, financial leasing companies and other Chinese financial institutions approved by the CBRC.⁶⁶ Article 2 implies that all Chinese commercial banks, including the Big Four, shareholding commercial banks and city commercial banks, could become target of foreign acquisitions.

Limitations on foreign equity investment were also set, according to Article 8 of FEI Regulation, individual foreign equity investment shall not exceed 20% of shares of capital or voting rights.⁶⁷ Total foreign equity investment in Chinese financial institutions shall not exceed 25%, otherwise this Chinese financial institution will be regarded as a foreign financial institution.

Of course, any foreign equity investments in Chinese financial institutions are subject to approval by the CBRC.⁶⁸ One deficiency of this regulation is that it does

⁶⁶ The original rule: Chinese financial institutions include commercial banks, urban credit cooperatives, rural credit cooperatives, trust investment companies, financial leasing companies and other Chinese financial institutions approved by the CBRC (My translation).

⁶⁷ The original rule: investment in Chinese financial institutions by foreign financial institutions shall not exceed 20% individually.

⁶⁸ See Ibid Article 4, the original rule: foreign investment in Chinese financial institutions is subject to approval of the CBRC.

not specify detailed procedure of foreign equity investment because the CBRC is merely responsible for supervision and authorization of bank business. Security business falls with the scope of security regulatory authority. Up to now, no relative rule has been promulgated.

4.7 Summary

In the Chinese financial market, both domestic banks and foreign banks are heavily regulated. Although China's entry into the WTO has significantly improved market access of foreign banks, but restrictions on foreign banks' market access still exist, how to penetrate the Chinese foreign market efficiently is a crucial question for European bank's growth. Next chapter will discuss European banks' market entry strategies in China.

Chapter 5

China's WTO Entry: Implications for European Banks'

Market Access in China

This chapter will deal with European banks' future market entry strategies after China's WTO entry. This part will be divided into two main sections: Greenfield Mode and M&A Mode.

5.1 Greenfield Mode

European banks may enter into the Chinese financial market in three forms, foreign bank branch, joint-venture bank or wholly owned foreign bank. Authorization requirements and business scope limitations are very similar, only different in degree (see Table 5.1). So I will combine these three modes in this section, which will discuss European banks' customer strategy, product strategy and business cooperation with local banks.

5.1.1 Customer Strategy

Bilateral trade and investment between the EU and China reached 126 and 23 billion Euros in 2002 respectively (Internalization Advantage).⁶⁹ More and more European companies started to establish plants in China. As indicated by Hui Dai (Chief Representative of Rabobank Beijing), European bank has traditional relationship with these companies in home country. These companies also wish to develop the relationship. Compared with Chinese bank, European banks have overwhelming advantages in this niche market. So when selecting customers,

⁶⁹ EUROSTAT (COMEXT, CRONOS) IMF (DOTS) WEFA (WMM)

European banks may take a “Follow Customer Strategy” to chase customers from their home country.

After 2006, customer limitations on foreign banks will be fully removed. European banks will have access to do business with Chinese customers. Most of Chinese premium customers locate in coastal cities. To successfully implement Seek New Customer Strategy, European banks should focus their efforts on these high quality customers.

5.1.2 Product Strategy

At present, the Chinese financial market adopts Segmented Operation Model; commercial banks are not allowed to engage in security, investment and insurance business (See section 4.2). While in Europe, Some European conglomerate banks can provide full range financial products (Ownership Advantage). To bypass Chinese legal limitations, European banks can offer insurance and investment service through their affiliated companies or subsidiaries. For example, after acquired Dresden bank in 2001, Allianz AG became a conglomerate firm specializing in banking, insurance and investment business. In China, Allianz AG operates both insurance business through its branch and bank business through Dresden bank, while Chinese banks can only offer commercial banking service. In this area, foreign banks have an overwhelming advantage compared to domestic banks. European banks will be more competitive if they take full advantage of Segmented Operation Model.⁷⁰

⁷⁰ Foreign bank’s advantage in this respect was well demonstrated in the “Ericsson Event”. In 2002, Ericsson (Nanjing) raised 240 million USD to pay off all its debt to Chinese banks and transfer all its business to CITI Bank Shanghai. This event happened only 4 months after China’s entry into WTO and caused an earthquake in the Chinese banking community. It was regarded as the fist face-to-face competition between Chinese banks and foreign banks. Trigger of this event is the inability of Chinese banks to carry out insurance business. CITI Bank provides a variety of financial services ranging from banking business, insurance business to investment related business through its affiliated company. Foreign banks are working in an integrated financial environment where banks can provide customers with full range financial products, while their Chinese counterparts can only offer

Table 5.1

Route to the Chinese Banking Market

Item	Foreign Invested Banks			Domestic Banks with Foreign Minority Investment
	Foreign branch	Wholly-owned foreign bank	Joint-venture bank	
Applicable Law	Law of the PRC on Commercial Banks, Operational Guidelines of Foreign Financial Institution			Law of the PRC on Commercial Banks
Limitation on Foreign Equity	NA	NA	NA	Individual Max 20%, total 25%
Working Capital	12-72 Million Euro		40-87 Million Euro	120 Million for a Commercial bank
Asset of the Investor	2.4 Billion USD	1.2 Billion USD	1.2 Billion USD	NA
Seasoning/ Representative Office in China	2Years	2Years	NA	NA
Prudential Requirement	30% of working capital deposit in bank approved by CBRC	Ratio of balance of liquid asset to balance of liquid debt at least 25% Fixed assets not to exceed 40% of equity Total foreign exchange deposit not to exceed 70% of total assets		Ratio of balance of liquid asset to balance of liquid debt at least 25% Ratio of balance of loans to balance of assets not to exceed 75%
Customer base	May provide service to foreign individuals and foreign enterprises upon accession May provide service to Chinese enterprises after Dec 11,2003. May provide service to Chinese individual after Dec 11,2006.			NA
Geographic Limit	Restricted (Details see Annex 2)			NA
Qualification of Enlargement of Chinese business Scope	Three 3 years business in China Two consecutive years' profit			NA

Source: "Operational Guidelines of Foreign Financial Institution in People Republic of China" adopted by the PBOC on Feb 7,2002, "Regulations on Foreign Equity Investment in Chinese Financial Institutions", adopted by the CBRC on DEC 31st, 2003.

However, it is impractical or impossible for all European banks to provide full range financial services in the Chinese financial market, especially for medium or small-sized European banks. European banks should carefully select products to meet customers' demand. As introduced by Ms. Andrea Fiori (Manager of Sanpaolo Imi Bank Beijing Branch), some European banks provide differentiated products in China, for example, WestLB AG Beijing Branch focuses on Forfaiting business; Dresden Bank Beijing Branch has a niche market in the Chinese capital business; Standard Chartered Bank have a leading position in trade finance and foreign currency settlement business.

5.1.3 Business Cooperation with Local Banks

As suggested by Nevin⁷¹ that transnational companies were changing from straight competition strategy to more collaborating and co-competing strategy. Cooperation with local firms will afford foreign banks local market knowledge and customer base.⁷² This implies that cooperation and collaboration is crucial for multinational enterprises' access to new market and further growth.

In the Chinese financial market, Chinese bank and European bank are not only competitors, but also copartners. As pointed out by Mr. Marc Poirier (China Country Manager of Societe General, Beijing), European bank's advantages consist of diversified financial products, high prestige in international market. Chinese bank can offer knowledge about local market and customers, broad branch networks, cognizance from the customers. Cooperation will help them to reach a win-win deal.

European and Chinese bank could cooperate in the following areas: issuance of Syndicated Loan to decentralize risks; cooperation in trade finance, especially in Factoring and Forfaiting business where European banks have more expertise knowledge; cooperation in RMB business to expand European banks' RMB capital base.

In one word, following China's WTO entry, cooperation and development for a

⁷¹ See Nevin, M., (2003), pp214.

⁷² See Haeri, M, F., (1990), pp 9.

win-win deal will benefit both European and Chinese banks.

5.2 M&A Mode

No matter how foreign banks enter into the Chinese financial market, be it in the form of a Foreign Bank Branch, Joint-Venture bank or Foreign Wholly-Owned Bank, they are all labeled as “foreign credit institutions”.⁷³ This implies that all explicit or implicit measures against foreigners apply to them. Is there any way to enter the market in the name of native?

In recent years, foreign banks are penetrating the Chinese financial market through minority equity investment in small and medium sized Chinese banks (see Table 4.2). The following section will talk about this strategy.

5.2.1 Minority Equity Investment Strategy

Theoretically, foreign banks are totally free to conduct business in China after 2006; geographic controls and client restrictions will be removed.⁷⁴ But in practice, there are onerous constraints to establish a foreign bank. According to current regulation, foreign banks are only allowed to apply for establishing one new branch per year.⁷⁵ After the branch is approved, it can't engage in RMB business immediately. It must have three years' business operation in China and show two consecutive years' profit.⁷⁶ Other measures such as excessive working capital requirements, high reserve capital requirements and liquidity will make branching too costly. Most of all, establishing a branch is still subject to government authorization.⁷⁷

⁷³ Foreign credit institution is a general term of foreign bank branch, joint-venture bank and wholly owned foreign bank, see Article 2 of Operational Guidelines for Foreign Financial Institution in People Republic of China adopted by the PBOC on Feb 7, 2002, the original rule: “foreign financial institutions ” mean financial institutions approved by home country authority and cooperated in China (My translation).

⁷⁴ WTO Ministerial Conference, “Report of the Working Party on the Accession of China” annexed to the Protocol of Accession of China, Nov 10, 2001, (WT/ACC/CHN/49).

⁷⁵ Article 14 of “Operational Guidelines for Foreign Financial Institution in People Republic of China” adopted by the PBOC on Feb 7, 2002, the original rule: foreign banks' application of establishing new branch shall be made one year after the approval of the previous branch (My translation).

⁷⁶ Ibid, Article 15, the original rule: application of establishing foreign bank branch is subject to the following criterion: 3 years' operation in China, 2 consecutive years' profit (my translation) .

⁷⁷ Ibid, Article 16, summary of the original rule: establishment of foreign bank branch is subject to the approval of the PBOC.

All the above measures are against foreigners, so entering the Chinese market in the name of a native will best solve this problem. According to Chinese legislation, Chinese banks with foreign investment not exceeding 25% percent of its shares or voting rights are still regarded as domestic banks. When foreign banks realized that branching is very time-consuming and costly, minority investment in local banks became an attraction.

5.2.2 Target Bank of Investment

In China, Policy banks and four State-Owned Commercial banks are wholly owned by the state. They are under heavy protection of the government, and it is impractical to acquire them at present.

City Commercial Banks only conduct business in the city of incorporation. Their branch networks are only limited in their native cities. Acquisition of these banks will not enable foreign banks to conduct business on a nationwide basis.

Compared with the Big Four, shareholding commercial banks are relatively small in size. But these newly established small players have better asset quality (see Table 4.1). Although these shareholding commercial banks' networks are not as broad as the Big Four, but they all have complete networks in major coastal cities where China's industrial and commercial hubs are located. Among 11 shareholding commercial banks, three of them are listed on Chinese stock exchange. Compared with non-public listed shareholding commercial banks, shares of public listed banks are more decentralized (see Table 5.2). It will be much easier for foreign investors to have a holding position in these banks. Investing in these three banks will enable foreign banks to raise fund in Chinese security market. So when considering acquisition or investing in the Chinese banking community, shareholding commercial banks, especially public listed banks, should be prioritized.

Table 5.2

Top 5 Shareholders of Chinese Shareholding Commercial Banks

		Name of the Bank	1st Largest Shareholder	2nd Largest Shareholder	3rd Largest Shareholder	4th Largest Shareholder	5th Largest Shareholder
Shareholding Commercial Banks	Non Public Listed Banks	Bank of Communications	49.7	6.7	3.7	3.5	3
		China Everbright Bank	N/A	N/A	N/A	N/A	N/A
		Huaxia Bank	14.29	11.43	11	8.57	4.29
		Industrial Bank of China	34	5	4.44	2.8	2.5
		Guangdong Development Bank	N/A	N/A	N/A	N/A	N/A
		CITIC Industrial Bank	N/A	N/A	N/A	N/A	N/A
		China Merchant Bank	17.95	8.61	5.7	3.19	2.53
	Yantai Housing Bank	N/A	N/A	N/A	N/A	N/A	
	Public Listed Banks	Shanghai Pudong Development Bank	6.44	4.87	4.85	4.62	4.02
		China Minsheng Bank	7.98	7.51	7.51	6.36	5.78
Shenzhen Development Bank		7.08	5.77	4.02	3.2	1.82	

Source: Official websites of the above banks⁷⁸

⁷⁸ Bank of Communications, <http://www.bankcomm.com/>, visited on April 21,2004,
China Everbright Bank, <http://www.cebbank.com/>, visited on April 21,2004,
Huaxia Bank, <http://www.hxb.com.cn/index1.htm>, visited on April 21,2004,
Industrial Bank of China, <http://www.999abc.com/WebSite6787.htm>, visited on April 26,2004,
Guangdong Development Bank, <http://ebank.gdb.com.cn/comminfo/index.jsp>,
visited on April 26,2004,
CITIC Industrial Bank, <http://202.108.253.133/citicib/>, visited on April 26,2004,
China Merchant Bank, <http://www.cmbchina.com/>, visited on April 26,2004,
Shanghai Pudong Development Bank, <http://www.spdb.com.cn/chpage/c1/>,
visited on April 26,2004,
China Minsheng Bank, <http://www.haodx.com/url/3985.htm>, visited on April 26,2004,
Shenzhen Development Bank, <http://www.sdb.com.cn/>, visited on April 26,2004.

5.2.3 Investment Incentives

Major incentives of foreign investments in Chinese banks are as following:

Acquisition of domestic banks' branch networks

In recent years, Chinese domestic banks achieved significant growth under the umbrella of protectionism. In some aspects, domestic banks have overwhelming advantages over foreign banks, for example the Industrial and Commercial Bank of China has a network of 20,000 branches all over the country.⁷⁹ As introduced by Winnie Wei (Assistant Manager, ING Bank Beijing), it is almost impossible or impractical for foreign banks to establish such a broad network. Strategic investment in domestic banks would enable foreign banks to indirectly acquire domestic banks' well-established branch networks.

Strategic investment opportunities

Compared with four state owned commercial banks, shareholding commercial banks have high-quality asset and healthier balance sheet. Investments in these banks will yield good returns. In addition, minority investments in Chinese banks will lead to full acquisition of these banks in the future.

5.2.4 European Bank's M&A Activities

Readers must be very astonished to find that six foreign acquisitions were concluded even these activities were prohibited by the law. All these cases were concluded on a case-by-case basis under government approval. According to my interview with HSBC, foreign equity investment in Chinese banks have taken the form of purchasing existing shares through private negotiation, or purchasing new shares.

In Dec 2001, only one month after China's entry into the WTO, HSBC acquired 8% equity stake in Bank of Shanghai. HSBC became the first foreign bank to be allowed to invest in Chinese banks. This deal started historical cooperation between Chinese banks and European banks. Strategic cooperation between Chinese banks and

⁷⁹ <http://www.icbc.com.cn/index.jsp>

European banks will yield fruitful result.

Foreign equity investment in Chinese banks is foreign banks' "Obtaining A Foothold Strategy"⁸⁰ to test the market. With China's continuous economic growth and further liberalization of financial market, M&A and full range cooperation between Chinese banks and European banks will be enhanced.

5.3 Summary

In the Chinese financial market, European banks adopt both Greenfield Mode and M&A Mode. Under Greenfield Mode, European banks should follow European enterprises and seek Chinese premium customers. Product factor should also be considered to find European banks' niche market. Cooperation with local banks will speed up European banks' market entry process.

In addition to traditional Greenfield Mode, European banks adopt M&A Mode by strategic investment in Chinese banks. This strategy will afford European banks immediate access to target market, well-established customer base and branch networks of local banks.

⁸⁰ See Molyneux, (2004), pp12.

Chapter 6

China's WTO Entry: Implications for Chinese bank's Market Access in the EU

6.1 Historical Background

The whole idea of creating a common market in Europe started from the Treaty of Rome (1957) which laid down the Community's goal: "*the Community shall have as its task, by establishing a common market (...) to promote throughout the Community a harmonious development of economic activities...*"⁸¹ In banking sector, the first important step was taken by adopting the 'First Banking Directive' 1977,⁸² the main achievement of the Directive was that member states were required to treat branches from other member states the same way as domestic credit institution.⁸³ But main obstacles concerning market access, such as authorization, endowment capital and economic needs test still exist. In 1985, the Commission issued its "White Paper"⁸⁴ to further integrate the internal market. The White Paper adopted new approaches of harmonization of essential standard, mutual recognition and home country control.⁸⁵

Freedom of capital movement is another pillar of integrated financial market. In EU, full liberalization of capital movement was actualized in 1988 when the Second Capital Directive⁸⁶ was adopted. This Directive imposed an obligation on member states to abolish all limitations on movement of capital between member states⁸⁷. Liberalization of capital movement paved the way of an integrated banking market⁸⁸.

⁸¹ See Article 2 EEC Treaty (The Treaty establishing the European Economic Community (EEC)).

⁸² Council Directive 77/780/EEC of 12 DEC, 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.

⁸³ Ibid, Article 4 (1).

⁸⁴ Com (85) 310 final of 14 Jun 1985.

⁸⁵ Ibid, para 101-107.

⁸⁶ Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

⁸⁷ Ibid Article 1.

⁸⁸ Article 51(2) of Treaty of Nice (Consolidated Version of the Treaty Establishing the European Community).

The whole idea of Second Banking Directive⁸⁹ is creation of “single banking license through mutual recognition”.⁹⁰ The Second Banking Directive applies to all credit institutions, as stipulated in Article 1 (1), 2(2) of the Second Banking Directive and Article 1 of the First Directive; a credit institution is defined as “an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account”. Creation of single banking license was combined with essential harmonization necessary to secure the mutual recognition by other member states.⁹¹ Supervision of credit institutions falls within the scope of home states. Home country authority is primarily responsible for the supervision of credit institutions incorporated in this country.⁹² Banking licenses obtained in home country will be valid throughout the Union. Credit institutions authorized by home country authority will be authorized to provide financial services and establish branches in other member states.⁹³ Credit institutions, authorized by home country authority to conduct activities listed on Annex to the Second Banking Directive, are also allowed to conduct those activities in any other member states.⁹⁴

The creation of Single Banking Market through the single banking license, the minimum harmonization of national banking law, mutual recognition and home country control, will offer banks more opportunities to expand at the EU level.

6.2 Current Situation

Chinese bank’s presence in Europe can be traced back to 1929 when Bank of China established the first Chinese bank branch in London. In the last two decades, due to continuous growth of trade between China and Europe (Internalization Advantage), more and more Chinese banks showed great interests in commercial presence in Europe.

Table 6.1 shows general situation of Chinese banks business in Europe. At present,

⁸⁹ Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC.

⁹⁰ Ibid, para 4 of the preamble.

⁹¹ Ibid.

⁹² Ibid.

⁹³ Ibid, para 12 of the preamble.

⁹⁴ Ibid.

Chinese banks have 8 branches and 2 wholly owned subsidiaries in Europe. Mr. Zhang Baoqiu, Manager of International Department of Bank of China, commented by saying: these banks are relatively small in size, but they acts as a scout of the whole bank to test local market (Obtaining a Foothold Strategy) and chase new customers (Seeking New Customer Strategy)”.

Table 6.1 Chinese Bank's business in the EU

Name of the Bank	Form of establishment	Amount in million USD	
		Time pf establishment	Asset by the end of 1996
Bank of China London Branch	Branch	1929	4000
Bank of China Paris Branch	Branch	1986	1000
Bank of China Frankfurt Branch	Branch	1989	600
Bank of China Luxembourg Branch	Branch	1979	1200
Bank of China Milan Branch	Branch	1998	N/A
China Construction Bank Frankfurt Branch	Branch	1999	270*
Industrial and Commercial Bank of China Frankfurt Branch	Branch	1999	325*
Industrial and Commercial Bank of China Luxembourg Branch	Branch	2000	561*
Bank of China International (UK) Limited	Subsidiary	1996	N/A
ICBC (London) Limited	Subsidiary	2003	N/A

Source: Official websites of the above banks⁹⁵

* By the end of 2002

⁹⁵ Bank of China London Branch, http://www.bank-of-china.com/org/c2_4.shtml, visited on May 02,2004,

Bank of China Paris Branch, http://www.bank-of-china.com/org/c2_4b.shtml, visited on May 02,2004,

Bank of China Frankfurt Branch, <http://www.bocffm.com/>, visited on May 02,2004,

Bank of China Luxembourg Branch, <http://www.bank-of-china.com/lu/index.html>, visited on May 02,2004,

China Construction Bank Frankfurt Branch, <http://www.ccbff.de/>, visited on May 02,2004,

Industrial and Commercial Bank of China Frankfurt Branch, http://www.icbc.com.cn/new_branch/hwfz/falankefu/index.html, visited on May 02,2004,

Industrial and Commercial Bank of China Luxembourg Branch, http://www.icbc.com.cn/new_branch/hwfz/lusenbao/index.html, visited on May 02,2004.

Due to lack of expertise knowledge about security and insurance business, Chinese bank branch mainly conducts traditional commercial banking business, such as acceptance of deposits, lending, trade finance and foreign exchange clearance. Most of Chinese banks' branches in Europe undertake the function of foreign exchange clearance center of the head office. For example, Bank of China Frankfurt branch is Bank of China's clearance center of Euro, while its London branch acts as clearance hub of Pound Sterling.

At present, Chinese banks have two subsidiaries in the EU, ICBC (London) limited⁹⁶ and Bank of China International (UK) Limited.⁹⁷ They mainly engage in investment and security business. Since Chinese banks are prohibited to conduct security and investment business within Chinese territory, these subsidiaries will help Chinese banks to accumulate expertise knowledge about new business and information about local market said Mr. Luo Xintao (Assistant Manager of ICBC Frankfurt).

6.3 The EU Rules on Market Access of Foreign Banks

At the Union level, the Council Directive 2000/12/EC⁹⁸ is a single text combined previous Directives regarding the business of credit institutions. This directive stipulates the general requirements and minimum standard relating to the taking up and pursuit of the business of credit institutions.

1) Definition of Credit Institutions

According to Article 1 of Directive 2000/12/EC, a Credit Institution is an undertaking whose business is to receive deposits and other repayable funds from the public and to grant credits for its own accounts.

2) Activities of Credit Institutions

As provided by Directive 2000/12/EC, the EU Credit Institutions are allowed to

⁹⁶ A wholly-owned subsidiary founded in 2003 by the Industrial and Commercial Bank of China

⁹⁷ A wholly owned subsidiary founded in 1996 by Bank of China.

⁹⁸ Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions.

conduct business ranging from acceptance of deposits, lending, financial leasing, money transmission services, foreign exchange, safe custody services, etc.⁹⁹ The long list annexed to the Directive implies “Universal Banking Model” which makes no difference between commercial banking and investment banking.¹⁰⁰

3) Conditions for Authorization

According to Directive 2000/12/EC, member states are required to verify that the following conditions are met before issuing a new banking license:

- credit institutions possess initial capital or own fund of no less than 5 million Euros,¹⁰¹ This is a minimum requirement, member states are free to impose more restrictive rules. According to Article 5 (2), member states are also free to grant authorization to particular categories of credit institutions initial capital as low as 1 million Euros.

- credit institutions are effectively directed by at least 2 persons with good reputation and sufficient experience to perform such duty,¹⁰² (the “four-eyes” principle), the main purpose of this requirement is to guarantee effective operation of the credit institutions.

- credit institutions have their head offices and carry on business in the member state where it is registered,¹⁰³

- credit institutions have a programme of operations regarding the types of business envisaged and the structural organization,¹⁰⁴

- credit institutions shall disclose the identities of all persons with qualified holdings¹⁰⁵ The intention of this measure is to avoid cross-financing and conflicting interests.¹⁰⁶ Member states shall be able to evaluate and reject any purchase or acquisition that could be inappropriate to sound bank management.¹⁰⁷

⁹⁹ Ibid, Annex 1.

¹⁰⁰ See Cranston, R., (1991), pp.26.

¹⁰¹ Article 5 of Council Directive 2000/12/EC OF THE European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions.

¹⁰² Ibid, Article 6(1)

¹⁰³ Ibid, Article 6 (2).

¹⁰⁴ Ibid, Article 8.

¹⁰⁵ Ibid, Article 7.

¹⁰⁶ See Nielsen, P. R., (1994), pp207.

¹⁰⁷ Ibid.

The above conditions are minimum requirements for authorizing a credit institution. Member states are free to impose more restrictive measures on credit institution incorporated within its territory.¹⁰⁸

4) Different Treatment to Branch and Subsidiary

Branch

A bank branch from non-member state gets its license from the member state where it is established under the identical condition applied to domestic banks of that member state.¹⁰⁹ The license is only valid within the territory of that particular member state.¹¹⁰ Therefore branch from non-member states will not enjoy the right of single bank license to provide service at the Union level.¹¹¹ As required by the Union legislation, member states shall not provide branches from non-member states more favorable treatments than that provided to branches from other member states.¹¹²

Subsidiary

Authorization of a non-EU bank subsidiary falls within the competence of member state where this subsidiary is incorporated. Once authorized, this subsidiary will acquire the status of Community legal entity. Compared with license of a bank branch, subsidiary's license (Single Banking License) is valid throughout the

¹⁰⁸ Preamble No.12 of DIRECTIVE 2000/12/EC OF The European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions.

¹⁰⁹ See "European Community and Its Member States Final Schedule of Special Commitments in Financial Services", World Trade Organization GATS/SC/31/Suppl.4/Rev.1,18 November 1999 (99-5018), http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm.

¹¹⁰ Preamble No. 19 of super note 99.

¹¹¹ According to Article 24 (3) of DIRECTIVE 2000/12/EC OF THE European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, the Community may, through agreements concluded in accordance with the Treaty with one or more third countries, agree to apply provisions which, on the basis of the principle of reciprocity, accord to branches of a credit institution having its head office outside the Community identical treatment throughout the territory of the Community. Although this article has never been invoked, it illustrated the Community's willingness to liberalize financial market to non-member states.

¹¹² Ibid, Article 24 (1).

Union.¹¹³ So a subsidiary will have market access at the Union level. In order to enjoy the right conferred by single banking market, a subsidiary must meet the following requirements:

- formed in accordance with law of one member state,¹¹⁴
- have its registered office, central administration or principle place of business in the Community,¹¹⁵
- have strong economic connection with a member state.¹¹⁶

Once the above-mentioned requirements are met, a non-EU bank subsidiary will be entitled to establish branch and provide service throughout the Union.

6.4 The EU Member States' Rules on Market Access of Foreign Banks

The current rule governing non-EU bank's market access in member states is "European Community and Its Member States Final Schedule of Special Commitments in Financial Services Nov 1999"¹¹⁷ (hereinafter called 1999 Schedule). In 1999 Schedule, the EU member states made different commitments in banking sectors. So non-EU banks will seek the most favorable place to settle down (Location Advantage). Germany, Luxemburg and Netherlands are still the most favorable countries for foreign banks, since there is no market access restriction on commercial presence (Mode 3).¹¹⁸ (See Table 6.2)

Whereas, other member states such as Austria, Finland, Greece, Portugal and

¹¹³ See "European Community and Its Member States Final Schedule of Special Commitments in Financial Services", World Trade Organization GATS/SC/31/Suppl.4/Rev.1, 18 November 1999 (99-5018), http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm.

¹¹⁴ Article 48 of Nice Treaty (Consolidated Version of the Treaty Establishing the European Community)

¹¹⁵ Ibid.

¹¹⁶ Supra note 98.

¹¹⁷ Super note 98.

¹¹⁸ See Gugler, P., (2004), "The WTO and the Race for Inward FDI in the European Union", pp69.

Sweden impose restrictive measures on non-EU bank's market access. Limitations main focus on nationality requirements, business scope limitations and government control.

Table 6.2

**Sector Specific Commitments in Banking and other financial services,
in the EU member states**

Country	Mode 3
Belgium	Restricted Market Access
Denmark	Restricted Market Access
Germany	N/A
Finland	Restricted Market Access
France	Restricted Market Access
Greece	Restricted Market Access
Ireland	Restricted Market Access
Italy	Restricted Market Access and National Treatment
Luxembourg	N/A
The Netherlands	N/A
Austria	Restricted Market Access
Portugal	Restricted Market Access
Spain	Restricted Market Access
Sweden	Restricted Market Access and National Treatment
United Kingdom	Restricted Market Access

Source: Gugler, P., (2004), pp 69.

For example, in Sweden, the managing director of a foreign bank branch shall reside in Sweden. At least 50% of board members shall be Swedish resident. A non-EU bank subsidiary may be established by one or several founders, one founding party shall either be a Swedish resident or be a Swedish legal entity.¹¹⁹

In Austria, a non-EU bank must obtain an approval from Austrian central bank

¹¹⁹ See: "European Communities and Their Member States Schedule of Specific Commitments", WORLD TRADE ORGANIZATION GATS/SC/31/Suppl. 4/Rev. 1 18 November 1999(99-5018).

before it conducts foreign exchange business.

It is worth noting that the above member states can only apply limitations to branches or subsidiaries directly established by non-EU banks, member states shall not apply the above limitations to non-EU subsidiary established in other member states unless these limitations also apply to subsidiaries of other member states.

6.5 Chinese Banks' Future Strategy in Europe

This part will discuss Chinese banks' future market entry strategy. This section is divided into two parts, i.e. Greenfield Mode and M&A Mode.

6.5.1 Greenfield Mode

Branch is the most typical business form of Chinese banks in Europe. As a dependent part of its head office, a branch has privilege over subsidiary in raising funds and issuing bonds because a bank branch conducts business in the name of head office. The main advantage of doing business in the form of branch is the benefit from brand name recognition and credit rating of the head office. So it is much easier for a bank to borrow money in international financial market through its branch. After the adoption of Euro, an integrated, efficient and matured capital market was established in Europe. Chinese banks can benefit from an integrated capital market through branching.

Liberalization of European financial market provides two opportunities to Chinese banks, namely Single Banking License and Universal Banking Model. As discussed in section 6.3.4, entering European market in the form of subsidiary will afford Chinese banks the benefit of Single Banking License and Universal Banking Model. As confirmed by Mr. Liu Jin (Manager of Industrial & Commercial Bank of China, London), with Single Banking License, Chinese bank will have the right to provide services and establish branches throughout Europe. Universal Banking Model will allow Chinese banks to conduct non-commercial banking business, which is forbidden in China. Conducting new business will afford Chinese banks expertise

knowledge about the market.

6.5.2 M&A Mode

Traditionally, Chinese banks' penetration into European is simply through establishing new networks. As discussed in section 6.4, limitations on market access of foreign banks still exist in some member states. It is still difficult for foreign banks to enter the EU financial market. Cooperation with local banks will help the newcomers to enter the market quickly. It is time for Chinese bank to think about M&As in Europe.¹²⁰

In the last decade, the European banking landscape is becoming more consolidated as a result of M&As activities. The number of credit institutions in major European countries Germany, Italy, Netherlands, Switzerland, the UK and France dropped 26%, 12%, 17%, 21%, 13% and 33% respectively.¹²¹ But the number of banks per 1000 habitant is about twice as large as in the US.¹²² This implies more bank concentration in the future. In 2002, concentration in the EU banking industry continued to grow. In most of the member states, M&A activities mainly involved small and medium-size banks.

Entering foreign market with help of local banks will significantly benefit Chinese banks. According to my interview with Chinese banks (ICBC, BOC and CCB), due to onerous legal limitations on M&A, these banks have no plan to acquire a European bank at the foreseeable future. So, I suggest M&A Mode as a long-term strategy.

As introduced by Mr. Wu Bin (General Manager of ICBC Luxembourg Branch) , strategic alliance is a good alternative to full acquisition of a local bank. Banks could

¹²⁰ See Jiang, B., Locke, P. & Willette, W., (2003), "Picking up the gauntlet: Bank competition in China after World Trade Organization entry", pp 247-253.

¹²¹ See Berger, A.N., Young, R.D., Udell, G. F., (2001), "Professional Forum Efficiency Barriers to the consolidation of the European financial services industry", pp.117-130.

¹²² See Beitel, P., Schiereck, D., & Wahrenburg, W., (2004), "Explaining M&A Success in European Banks", pp109-139.

form alliance to provide more sophisticated products to the customers without physical establishment in foreign country.¹²³ Strategic alliance can also take the form of cross-shareholding or board representation, which will afford Chinese banks with more knowledge about western-style management and local market.

6.6 Summary

At present, Chinese banks penetrate the European financial market through Greenfield Mode. Chinese banks will benefit from brand name recognition and credit rating of the head office by establishing a branch. Establishing a wholly owned subsidiary will afford Chinese banks the benefit of Single Banking License and Universal Banking Model. At a long-term strategy, Chinese banks should think about M&A Mode to enter into European financial market in the future.

¹²³ See Buch, C. M., & DeLong, G. L., (2002) "Cross-Border Bank Mergers: What Lures the rare Animal?", Kiel Institute of World Economics, Working Paper 1070, Kiel, PP10-21.

Chapter 7

Conclusion

This paper provides an overview of the impact of China's entry into the WTO on market access of European banks in China and Chinese banks in Europe.

Historically, the Chinese financial market has been heavily regulated by the government. Foreign banks' market access was strictly controlled. After China's entry into the WTO, China speeded up her pace to liberalize financial market. But some problems still exist, such as high threshold of entry and quantitative restrictions. In the EU, the establishment of Single Market and adoption of the EMU have significantly eliminated trade barriers. But restrictive measures on non-EU banks' market access also exist in some member states. How to can European banks penetrate into Chinese market effectively by exploiting their major strength, i.e. OLI Paradigm, and vice-versa is of much concern both to European banks and Chinese banks.

Successful market entry can be achieved either through Greenfield Mode or M&A Mode.

European banks adopt both Greenfield Mode and M&A Mode to penetrate into the Chinese financial market. Under Greenfield Mode, European banks should follow European enterprises and seek Chinese premium customers. Product factor should also be considered to find European banks' niche market. Cooperation with local banks will speed up European banks' market entry process. Except traditional Greenfield Mode, European banks adopt M&A Mode by strategic investment in Chinese banks. This strategy will afford European banks immediate access to target market, well-established customer base and branch networks of local banks.

At present, Chinese banks penetrate the European financial market through Greenfield Mode. Chinese banks will benefit from brand name recognition and credit rating of the head office by establishing a branch. Establishing a wholly owned subsidiary will afford Chinese banks the benefit of Single Banking License and

Universal Banking Model. With Single Banking License, Chinese banks will have the right to provide services and establish branches throughout the EU. Universal Banking Model will allow Chinese banks to conduct non-commercial banking business that is forbidden in China. I also suggest M&A Mode as a long-term strategy to Chinese banks.

7.1 Suggestion for Future Study

Entering into foreign market through acquiring a local bank is more attractive than building up new branch network. There are disadvantages as well; onerous legal limitations on M&A and cultural difference between two countries could make it difficult to integrate two banks. I did not discuss these factors in this paper. I hope this study can provide some information for future research.

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QUESTIONNAIRE I (To European banks in China)

1. What are the main business scopes of your bank before China's WTO entry?
 - a. RMB business
 - b. Foreign currency business
 - c. Both
2. What is the geographic coverage of your banking license?
 - a. Only the city where your bank is registered
 - b. The city where your bank is registered and neighboring cities.
3. What kind of customers can you provide service to?
 - a. Foreign enterprises
 - b. Foreign individuals
 - c. Chinese enterprises
 - d. Chinese individuals
4. What are the main changes to business scope, geographic coverage of banking license and customer base after China's WTO entry?
5. What are the main problems effecting market access after China's WTO entry?
 - a. High Threshold of Entry
 - b. Business scope limit
 - c. Quantitative limit
6. How do you comment on the extra market access enjoyed by foreign banks in China? i.e. foreign banks are allowed to conduct investment, insurance and security business through their subsidiaries.
7. What are the main advantages and disadvantages of establishing a branch, joint venture bank or wholly owned bank?
8. What is your comment on "Foreign equity investment" in Chinese banks?
9. Does your banks have any plan to invest in Chinese banks?
10. If so, what kind of banks are you going to invest?
 - a. Stated owned banks
 - b. Shareholding commercial banks

- c. City commercial banks
11. what is your bank's future market entry strategy?
- a. Establish more branches or subsidiaries
 - b. Through invest in local bank
 - c. Through M&A with local bank

QUESTIONNAIRE II (To Chinese banks in Europe)

1. What is your bank's main business in Europe?
 - d. Serving Chinese companies in Europe
 - e. Involving in European market
 - f. Serving as a foreign currency settlement center for the Head Office.
2. What is your bank's business form in Europe?
 - a. Branch
 - b. Subsidiary
 - c. Other
3. What are the main changes to market access after China's WTO entry?
4. What are the major problems effecting Chinese bank's market access in Europe?
5. Except European legislation and law of member states, does Chinese legislation affect Chinese bank's market access in Europe? If so, how does it affect market access?
6. What are the main advantages and disadvantages between establishing a branch and a subsidiary in regard to market access?
7. Does your bank have any plan to invest in European bank in the future?
8. How will your bank enter European market in the future?
 - a. Branch
 - b. Subsidiary
 - c. Investment in European banks
 - d. M&A

ANNEX I

ACTIVITIES LIST OF ACTIVITIES OF CREDIT INSTITUTION SUBJECT TO MUTUAL RECOGNITION

1. Acceptance of deposits and other repayable funds
2. Lending (Including, *inter alia*, consumer credit, mortgage credit, factoring, with or without recourse, financing of commercial transactions (including forfeiting).
3. Financial leasing
4. Money transmission services
5. Issuing and administering means of payment (e.g. credit cards, travelers' cheques and bankers' drafts)
6. Guarantees and commitments
7. Trading for own account or for account of customers in:
 - (a) Money market instruments (cheques, bills, certificates of deposit, etc.)
 - (b) Foreign exchange;
 - (c) Financial futures and options;
 - (d) Exchange and interest-rate instruments;
 - (e) Transferable securities
8. Participation in securities issues and the provision of services related to such issues
9. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings
10. Money broking
11. Portfolio management and advice
12. Safekeeping and administration of securities
13. Credit reference services
14. Safe custody services

Annex 2 China's WTO Accession Agreement in the Banking Sector

1. Geographic coverage

For foreign currency business, there will be no geographic restriction upon accession;

For local currency business, the geographic restriction will be phased out as follows:

- upon accession, Shanghai, Shenzhen, Tianjin and Dalian;
- within one year after accession, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan;
- within two years after accession, Jinan, Fuzhou, Chengdu and Chongqing;
- within three years after accession, Kunming, Beijing and Xiamen;
- within four years after accession, Shantou, Ningbo, Shenyang and Xi'an.
- within five years after accession, all geographic restrictions will be removed.

2. Except for geographic restrictions and client limitations on local currency business, foreign financial institution may do business, without restrictions or need for case-by-case approval, with foreign invested enterprises, non-Chinese natural persons, Chinese natural persons and Chinese enterprises.

3. For financial leasing services, foreign financial leasing corporations will be permitted to provide financial leasing service at the same time as domestic corporations.

4. Clients

For foreign currency business, foreign financial institutions will be permitted to provide services in China without restriction as to clients upon accession. For local currency business, within two years after accession, foreign financial institutions will be permitted to provide services to Chinese enterprises. Within five years after accession, foreign financial institutions will be permitted to all Chinese clients. Foreign financial institutions licensed for local currency business in on region of

China may service clients in any other region that has been opened for such business.

5. Licensing

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

- Foreign financial institutions who meet the following condition are permitted to establish a subsidiary of a foreign bank or a foreign finance company in China:

- Total assets of more than USD10 billion at the end of the year prior to filing the application.

- Foreign financial institutions who meet the following condition are permitted to establish a branch of a foreign bank in China: •

- Total assets of more than USD20 billion at the end of the year prior to filing the application.

- Foreign financial institutions who 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 USD10 billion at the end of the year prior to filing the application.

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.