

Foreign Banking in China: Opportunities for U.S. Investors in the 1990s

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“Is it not a pleasure to have friends come from afar?”

—Confucius, in the opening passage
of *The Analects*

A first glimpse of the People's Republic of China (“China” or “PRC”) China reveals an underdeveloped industrial base, a repressive Marxist-Leninist-Maoist government, a pervasive and all-encompassing bureaucracy, a fragmentary legal structure, and an economic system that has adopted a few of the good and many of the bad lessons of capitalism. But with an economy predicted to be the world's largest by the year 2010,¹ investors from the far corners of the earth have been flocking to set up joint ventures, wholly foreign-owned enterprises, and foreign banks.

American companies, however, have been relatively slow to take advantage of new investment opportunities in China.² Perhaps, as a wise man once said, “The only thing preventing Tzu-lu from applying what he had heard was the fear that he needed to hear something more.”³ This article endeavors to provide the requisite “something more” to enable U.S. bankers to make informed decisions about the type of financial institution to establish in China.

I. INTRODUCTION

The continued internationalization of the service sector is inevitable if China wants to compete in world markets and attract more foreign

1. Jim Rohwer, China: The Titan Stirs, *Economist*, Nov. 28, 1992, at 3, 5 (Supp.). Predictions that China's economy will match the U.S.'s by 2020 are based on four assumptions: (i) that the domestic stability in China continues; (ii) that China continues to open to the outside world; (iii) that the rate of technological and scientific development continues; and (iv) that China implements a market economy. See David Holley, China: The Giant Awakens; Ancient Power Steps into Asian Spotlight, *L.A. Times*, June 15, 1993 (*World Report*), at 1.

2. From 1985-1992, the U.S. share of total foreign investment was estimated at 9%, or US\$2,797 million, compared with \$21,367 million from Hong Kong and Macao and \$3,729 million from Japan. See A Foreign Invasion (chart), *Wall St. J.*, Dec. 10, 1993, at R3. See also Foreign Economic Trends and Their Implications for the United States (American Embassy, Beijing, China), May 1992, at 10 (on file with the author).

3. A well-known Chinese proverb.

investment.⁴ Along with foreign insurance companies and law firms, foreign banks are taking advantage of recent reforms.⁵ Licensed to operate representative offices on the mainland for over a decade, foreign banks were authorized to open branches in the Special Economic Zones in 1985⁶ and in cities from Dalian to Guangzhou in 1992.⁷ Since The First National Bank of Chicago and the Bank of Tokyo located representative offices in Beijing in 1980,⁸ over fifty-five foreign bank branches have been opened and 260 banks and financial institutions have established agencies in fourteen cities.⁹

The Ministry of Finance's Bai Duoguang explained the drive to encourage foreign banks and capital to invest in the PRC as "... one of the major components in China's long-term reform and open-door policy."¹⁰ Other Chinese officials have similarly indicated their conviction that the benefits of opening the banking industry far outweigh any costs.¹¹ Foreign banks attract foreign clients and investors which, in turn, bring new technology, advanced facilities, and effective management methods into China.¹² Foreign financial institutions further accelerate development, finance new business ventures, enhance

4. See *China May Open Service Sector to Foreign Cash*, Reuter Library Report, Apr. 19, 1992, available in LEXIS, Asiapc Library, Allnws File (citing China Daily which quoted Yu Xiaosong, China's vice minister of foreign trade, as stating that an infusion of foreign capital and expertise into the service sector would help internationalize China's economy). See also *China is Drafting Liberalized Import Regulations, Dumping Law, Official Says*, Int'l Trade Rep. 2052 (1992) (suggesting that the GATT will require China to open its service industry to foreign investment).

5. See Noel Fung, *Patience Key in Banking on China*, S. China Morning Post, Oct. 16, 1993 (Supp.), at 20; Liu Weiling, *China Fever Breaks Out Among Banks in America*, China Daily, Sept. 19, 1993 (Business Weekly Supp.), available in LEXIS, Asiapc Library, Txtfe File; *More Foreign Banks to be Allowed to Operate in China*, Ching-Chi Tao-Pao [China Economic News], June 1, 1992, at 29, translated in F.B.I.S., June 11, 1992, at 35.

6. The Special Economic Zones ("SEZs") are five zones in the southeastern provinces of China designed to attract foreign investment. See *infra* note 79 and accompanying text.

7. See discussion *infra* III(B)(1)(c).

8. Telephone Interview with David Warner, Vice President, The First National Bank of Chicago (Mar. 31, 1993). See also Anthony Rowley, *Japanese Banks' Reluctant Presence in China*, Bus. Times, June 14, 1993, at 6, available in LEXIS, Asiapc Library, Bustms File.

9. Joe Zhang, *China: Factors Behind China's Inflation*, Australian Financial Review, Oct. 4, 1993, available in LEXIS, Txtlne Library, Txtlne File.

10. Ministry Releases Document on Foreign Loans, Zhongguo Tongxun She, Sept. 27, 1991, reprinted in F.B.I.S., Sept. 30, 1991, at 43, 43.

11. See, e.g., Mo Xinyuan & Zhang Jinsheng, Li Peng, Zou Jiahua on Tertiary Industries, Xinhua Domestic News Service, Nov. 6, 1992, translated in F.B.I.S., Nov. 9, 1992, at 38, 38.

12. Expanded Foreign Bank Activities Viewed, Xinhua General Overseas Service, May 6, 1992, translated in F.B.I.S., May 7, 1992, at 36-37.

competition, raise revenue for the government through taxes, and help create a sound economic environment.¹³ Concerns that competition from foreign banks might damage the Chinese financial system and that foreign banks might manipulate the financial market, however, led national and local authorities to combine this new "openness" with strict control of foreign banking operations.¹⁴ The resulting regulations significantly restrict foreign banks' business activities, limit the geographic areas in which they are permitted to branch, and establish a bureaucracy to closely monitor their activities.

Foreign bankers today are painfully aware of the limitations of entering China's financial market. During the early 1980s, foreign banks rushed through the "Open Door," eager to establish representative offices and provide foreign currency loans. To gain a foothold in the new market, they made "friendship" loans at cut-rate prices.¹⁵ These loans were considered low-risk because foreign bankers believed that they were extending credit to divisions of "China, Inc.," guaranteed *de facto* by the Chinese government.¹⁶ After Tiananmen, however, the recessionary austerity programs led to loan defaults, and foreign banks often found themselves with no way to collect or to enforce guarantees.¹⁷ Many banks therefore either suspended lending to the PRC or began to scrutinize the creditworthiness of Chinese guarantors and the quality of documentation more carefully.¹⁸ It is not surprising that foreign bankers greeted the improved economic climate of the early 1990s with caution. But 1993 ushered in a new era for foreign banking in China. The liberalized banking environment, double-digit gross domestic product growth, and flourishing real estate, security, and

13. See Responsible Person from the State Administration of Exchange Control Interviewed by XINHUA Reporter on Published Foreign Debt Figures, Xinhua Domestic News Service, Sept. 2, 1991, translated in F.B.I.S., Sept. 3, 1991, at 44; Mark B. Baker et al., *Foreign Banks in China: The Legal Framework*, 6 China L. Rep. 87, 91-92 (1990).

14. Baker, *supra* note 13, at 90-91.

15. Sumner Gerard, *US Banks' Tougher Approach*, China Bus. Rev., May-June 1989, at 24, 24.

16. Frank Moy, *Sovereign Risk in PRC Lending*, China Banking & Fin., Oct. 1, 1990, at 2. As all enterprises in China were state-owned and/or controlled, foreign lenders often viewed loans to these government entities as sovereign debt and ultimately PRC country debt. *Id.*

17. See Michael Ipson, *China's Foreign Debt*, China Banking & Fin., June 17, 1991, at 2 (providing detailed information about debt collection before and after Tiananmen). See *infra* Section V(A)(1)(a).

18. World - Financing Profiles (Algeria-Japan), Market Reports, May 14, 1993, available in LEXIS, Market Library, Mktrpt File.

capital markets are once again drawing the dollar, yen and mark to China.¹⁹

This article provides an overview of China's domestic banking system as well as an analysis of the three primary vehicles available to foreign bankers who aspire to penetrate China's financial market. Section II summarizes the domestic banking system in China. Section III describes the three primary options open to foreign banks, specifically representative offices, branches, and joint-venture banks. Section IV considers the relative merits of representative offices, branches, and joint venture banks, examining the limitations and advantages of each and drawing some preliminary conclusions.

Section V explores many of the problems that plague foreign bankers in China. This section takes the form of a case study of the loan defaults of the late 1980s and the regulatory measures adopted by Chinese authorities to combat the factors perceived as contributing to the crisis. Finally, Section VI summarizes and draws some initial conclusions for foreign banks interested in infiltrating the Chinese market.

II. THE FRAMEWORK OF CHINA'S DOMESTIC BANKING SYSTEM

Foreign banks have secured only a small niche in China's sprawling financial sector. Overseeing China's banking system are the Ministry of Finance and the People's Bank of China (the "PBOC").²⁰ The PBOC ostensibly serves as China's central bank, regulating and supervising both domestic and foreign banks, setting interest rates on deposits and loans, and exerting control over the money supply through interest rates and loan quotas imposed on specialized and commercial banks.²¹ The degree of control that the PBOC actually exercises over the commercial banks and its own branches is debatable, however.²² As

19. See Weiling, *supra* note 5 (describing American banks in China); Tony Walker, *Dresdner Bank to Open Branch in Shanghai*, *Financial Times*, July 17, 1993, at 29 (describing German banks in China); Rowley, *supra* note 8, at 6 (describing Japanese banks in China). See also Lincoln Kaye, *Bringing Up the Rear - Fast, Far E.* *Econ. Rev.*, Sept. 24, 1992, at 60.

20. See *The Monetary System: Financing Foreign Operations*, Dec. 1, 1992, available in LEXIS, World Library, Allwld File. Both the Ministry of Finance and the PBOC fall under the auspices of the State Council, the administrative arm of China's central government.

21. Valerie Chang, *The New Look of China's Banks*, *China Bus. Rev.*, May-June 1989, at 20, 20.

22. See *Asian Trade Service Guide - China*, *Euromoney Trade Fin. and Banker Int'l*, Sept. 1, 1993, available in LEXIS, Asiapc Library, Allasi File.

a result of the fragmentation of central government power in the 1980s,²³ directors of commercial banks and PBOC branches in the provinces are more likely to follow the directives of local officials than they are those of central authorities.²⁴

Recently, steps have been taken to bring back some measure of central control over the banking system. In July of 1993, the PBOC and its influential new governor, Zhu Rongji, initiated a crackdown on regional banks in an attempt to restrict money supply and cool China's overheated economy.²⁵ According to PBOC deputy governor Chen Yuan, the PBOC has further slated banking reforms for later this year to bring regional banks in line and reinforce the PBOC's authority.²⁶ Regardless of these efforts, at present, many of the problems surrounding decentralization remain.

As an arm of the PBOC, it is worth separately mentioning the State Administration of Exchange Control ("SAEC"), which acts as a regulatory watchdog for the PBOC and controls all foreign exchange transactions in China.²⁷ The foreign exchange position of all domestic and foreign banks and enterprises is closely monitored by the SAEC.²⁸

The Ministry of Finance, in contrast to the PBOC, has no direct authority to regulate banking, but has exerted considerable power over the PBOC as a result of its role in enforcing the national budget;²⁹ in the past, to stem the tide of China's growing budget deficit, the Ministry of Finance would make overdrafts on the PBOC, forcing the PBOC to issue more money.³⁰ The influence of the Ministry of Finance in the banking sector, however, may have recently been curtailed as a result of government reforms that would cause future borrowing to take the form of bonds rather than PBOC overdrafts.³¹

23. See Holley, *supra* note 1, at 1 (describing the movement away from a centrally planned economy).

24. See Asian Trade Service Guide - China, *supra* note 22.

25. Sally Gelston, China Moves to Cool Inflation, *E. Asian Executive Rep.*, July 15, 1993, at 5, 5.

26. See Noel Fung, Currency, Bank Reform Next Year, *S. China Morning Post*, Oct. 19, 1993 (Business), at 2, available in LEXIS, Asiapc Library, Buchin File.

27. See The Monetary System, *supra* note 20.

28. See *infra* Section V(B)(1).

29. See The Monetary System, *supra* note 20.

30. *Id.*

31. See Capital Sources: Investing Licensing & Trading, Feb. 1, 1993, available in LEXIS, World Library, Allwld File.

For decades after the creation of the People's Republic, the PBOC served as a commercial bank in addition to carrying out its central bank functions.³² By 1980, however, its swollen bureaucracy proved insufficient to the demands of China's economic modernization.³³ As a result, the PBOC was reformed and stripped of its commercial banking capabilities which were divided among five different banks.³⁴

Although each of these five banks originally had a designated position in China's economy,³⁵ the lines which separate their roles have become increasingly blurred over the past few years.³⁶ Nevertheless, while the following objectives are often no longer exclusive, they may be regarded as integral functions:

THE BANK OF CHINA. The Bank of China handles foreign exchange transactions, manages China's foreign currency reserves, and engages in lending within the international Eurocredit markets.³⁷ In addition, it trades in overseas securities, issues bonds on the international market, and establishes correspondent relations with foreign banks.³⁸

THE INDUSTRIAL AND COMMERCIAL BANK. China's largest commercial bank, the Industrial and Commercial Bank provides credit for transportation, communications, engineering, textiles, and other projects in China's major cities.³⁹

THE PEOPLE'S CONSTRUCTION BANK. The People's Construction Bank evaluates, manages, and finances large construction projects.

AGRICULTURAL BANK OF CHINA. The Agricultural Bank of China is responsible for supervising rural credit cooperatives.⁴⁰

32. See Sander G. Tideman, *Dealing with Nonconvertability and Other Financial Aspects of Doing Business in China*, E. Asian Executive Rep., July 15, 1993, at 16, 16-17.

33. *Id.* at 16; See Gelston, *supra* note 25, at 5; See also Chang, *supra* note 21, at 20.

34. See Capital Sources, *supra* note 31.

35. *Id.*

36. *Id.*

37. See Asian Trade Service Guide - China, *supra* note 22. The Bank of China was initially the only Chinese bank authorized to handle foreign exchange. Today, however, all of the specialized banks offer foreign exchange services. See Tideman, *supra* note 32, at 16.

38. See The Monetary System, *supra* note 20.

39. *Id.*

40. *Id.*

CHINA INVESTMENT BANK. Falling under the direct authority of the Ministry of Finance, the China Investment Bank was established to channel loans from the World Bank and other international institutions to Chinese enterprises.⁴¹ Its role was expanded considerably in 1992 to raise capital from private sources abroad, issue bonds, invest in export enterprises and joint ventures, and purchase stock on the securities markets.⁴²

In addition to the five specialized banks described above, China has a host of other commercial banks, all of which come within the scope of the PBOC's regulatory powers. These commercial banks primarily provide services to large state enterprises, many of which double as the commercial banks' shareholders.⁴³ The Bank of Communications and the China International Trust and Investment Corporation Industrial Bank ("CITIC Industrial Bank") are the two largest and most influential of the commercial banks. The Bank of Communications, one of China's major financial institutions before 1949, was re-established in Shanghai in 1987 and has become the PRC's fifth largest bank.⁴⁴ CITIC Industrial Bank is a wholly-owned subsidiary of the China International Trust and Investment Corporation ("CITIC"), a large corporate conglomerate with its hand in almost every profitable sector of China's economy, including banking, trade, investment, travel, and real estate.⁴⁵

Forming an additional tier of banks under the PBOC are hundreds of regional international trust and investment corporations.⁴⁶ Established in each province to attract foreign investment, these banks are administered by state and local governments or by the five specialized banks and primarily offer consulting and investment banking services.⁴⁷

41. *Id.*

42. *Id.*

43. See *Capital Sources*, *supra* note 31.

44. See *The Monetary System*, *supra* note 20.

45. *Id.* CITIC, CITIC Industrial Bank's parent company, reports directly to the State Council.

Id.

46. See *Capital Sources*, *supra* note 31.

47. *Id.*

III. VEHICLES FOR INVESTMENT

China is continuing its efforts, initiated in the early 1980s, to reform its domestic banking system. The entry of foreign banks into China is an integral part of this reform process.⁴⁸ Foreign banks eager to take advantage of the market opportunities should, however, be aware of the different investment options available and their attendant advantages and disadvantages.

Foreign investors have three primary vehicles to penetrate China's financial market: representative offices, bank branches, and joint venture banks. Representative offices provide introductions and contacts, credit analysis, and product promotion for their parent banks, but are prohibited from engaging in any profit-making activities. While representative offices incur considerable expenses, their services prove extremely valuable for the foreign bank's overseas branches. In addition, these banks secure a foothold in the China market for the later introduction of branches or joint ventures. Bank branches generally offer commercial banking services, such as lending, accepting deposits and financing trade, as well as underwriting securities and trading in foreign currency and bonds. The ability of these branches to compete in the domestic currency market, however, is frustrated by restrictions on transactions involving *renminbi* ("RMB"), China's soon to be convertible national currency. Joint venture banks function similarly to and are governed by the same regulations as foreign bank branches. Although the inclusion of a Chinese partner allows foreign bankers greater access to potential domestic borrowers, more freedom to branch within China, and a valuable link to "inside" information, it greatly reduces foreign bankers' control over finances.

A. Representative Offices

The representative office served as the first investment vehicle available to foreign banks after China adopted its "Open Door" policy in 1979. Of the three alternatives to be considered by foreign banks, it is the most limited because it is prohibited from engaging in profit-

48. See Ministry Releases Document on Foreign Loans, *supra* note 10.

making activities.⁴⁹ Nevertheless, a representative office can prove lucrative by connecting potential clients on the mainland with the bank's offices outside of China. The presence of a representative office can also smooth the way for a foreign bank later to establish a branch office or enter into a joint-venture in China.⁵⁰

1. Legal Framework

The representative offices first appeared after the government issued regulations in 1980 allowing financial institutions and other foreign enterprises to set up resident offices in the PRC.⁵¹ In 1983, the PBOC issued provisional regulations to control representative offices more effectively.⁵² These regulations were repealed by the PBOC in 1991 and replaced with the Administration of the Establishment of Resident Representative Offices in China by Financial Institutions with Foreign Investment Procedures ("1991 Representative Office Procedures").⁵³

The 1991 Representative Office Procedures apply to all foreign representative offices of banks, securities companies, investment companies, insurance companies, financial services companies, credit card companies, and finance leasing companies.⁵⁴ Under these procedures, the PBOC oversees the examination, approval, and administration of such representative offices.⁵⁵

2. Functions of Representative Offices

Sanctioned to engage in "consulting, liaison, market research, and other nonprofit making activities," representative offices provide a parent bank with introductions to and contacts with Chinese local

49. Administration of the Establishment of Resident Representative Offices in China by Financial Institutions with Foreign Investment Procedures, art. 8 [hereinafter 1991 Representative Office Procedures], translated in *China Banking & Fin.*, July 22, 1991, at 5.

50. See *China - Restrictions on Banks*, Market Reports, May 13, 1992, available in LEXIS, Market Library, Mktrpt File.

51. See Baker, *supra* note 13, at 87.

52. Provisional Regulations of the People's Republic of China for the Establishment of Resident Offices of Foreign Enterprises § 801030, in *Statutes and Regulations of the People's Republic of China* (1988 update).

53. See 1991 Representative Office Procedures, *supra* note 49.

54. *Id.* art. 2.

55. *Id.* art. 4.

authorities and enterprises, perform credit analyses and supply economic information, introduce the products and promote the services of the parent bank, and explore business opportunities in China.⁵⁶ Both the 1991 Representative Office Procedures and the earlier regulations expressly prohibit representative offices from conducting any profitable commercial banking operations, including initiating business, making loans, accepting deposits, or following up on letters of credit.⁵⁷ During the late 1980s, many representative offices seeking to expand their activities in China began discounting trade bills for importers and exporters and confirming letters of credit, often setting up hotel room offices in new cities to facilitate this business.⁵⁸ The PBOC turned a blind eye to these violations until the Bank of China, in an effort to protect its own trade business, exerted pressure on the central bank.⁵⁹ A June 1990 PBOC circular restricted the business activities of representative offices⁶⁰ and such offices were no longer able to "collect, canvass for, pass on or check trade bills for their head offices and branches."⁶¹ PBOC branches were called on to investigate representative offices in their respective cities, and several foreign banks received warnings.⁶²

3. Disclosure Requirements

An application must be made to the PBOC whenever a representative office replaces or increases the number of its representatives, employs Chinese advisors or workers, or changes its name or address.⁶³ Each February, representative offices must also

56. *Id.* art. 8. See also Henry R. Zheng, *Foreign Banking in the People's Republic of China: Laws and Practice*, 21 *Int'l Law.* 437, 448 (1987).

57. 1991 Representative Office Procedures, *supra* note 49, art. 8; Provisional Regulations for the Establishment of Representative Offices in China by Overseas Chinese and Foreign Financial Institutions, *supra* note 52, art. 8. See also Kevin Rafferty, *Slim Pickings for Foreign Banks*, 20 *Institutional Investor* 215 (1986).

58. See Tai Ming Cheung, *Back to the Basics: China Clamps Down on Foreign Banks*, *Far E. Econ. Rev.*, June 28, 1990, at 76; Geoff Crothall, *Regulations Covering Foreign Banks Tightened*, *S. China Morning Post (Business)*, June 6, 1990, at 1; P.T. Bangsberg, *China Clamps Down on Foreign Banks*, *J. of Com.*, June 7, 1990, at 3A.

59. See Crothall, *supra* note 58, at 1; Bangsberg, *supra* note 58, at 3A; *People's Bank Restricts Foreign Bank Activities*, *China Banking & Fin.*, June 18, 1990, at 2.

60. See Cheung, *supra* note 58, at 76.

61. Crothall, *supra* note 58, at 1.

62. See *id.*

63. 1991 Representative Office Procedures, *supra* note 49, arts. 9-11.

present a "report" to the local branch of the PBOC.⁶⁴ The 1991 Representative Office Procedures grant the PBOC authority to take "measures" against offices that fail to meet any of these requirements.⁶⁵

In cases where a representative office believes that measures taken by the PBOC are inappropriate, it can apply for administrative review under the Regulations on Reconsideration of Administrative Measures.⁶⁶ Adopted in 1991 by the National People's Congress, the Regulations on Reconsideration of Administrative Measures subject the following administrative actions to review: administrative penalties involving fines, demands that businesses cease operations, and confiscation of property; administrative decisions violating the right of self-management; and administrative refusal to act on legitimate applications for permits or licenses.⁶⁷

After rendering a decision on the review of an administrative action, the reviewing agency is empowered to enforce its conclusions, and parties who fail to implement a verdict may be subjected to disciplinary action.⁶⁸ Likewise, personnel within the reviewing agency itself may be subjected to punishment if they are found obstructing the review process or otherwise abusing their powers.⁶⁹

Both the Ministry of Finance and the PBOC have implemented measures to carry out the requirements of the Regulations on Reconsideration of Administrative Measures.⁷⁰

64. *Id.* art. 14.

65. *Id.* art. 17.

66. Regulations on Reconsideration of Administrative Measures, BBC Summary of World Broadcasts, 1991, available in LEXIS, World Library, Bbeswb File. Decisions made by the administrative offices of local people's governments at the county level or higher are reviewed by the next highest level of the people's government. The administrative acts of departments under direct control of the State Council, such as the central PBOC, are reviewed internally by the departments themselves. *Id.* art. 11.

67. *Id.* arts. 9, 10.

68. *Id.* art. 52.

69. *Id.* arts. 53, 54.

70. Ministry of Finance, Financial Departments Administrative Review Regulations, translated in *China Banking & Fin.* Sept. 30, 1991, at 8; People's Bank of China, Administrative Review Procedures, translated in *China Banking & Fin.*, May 14, 1992, at 5.

4. Establishing a Representative Office

There are no official restrictions on where a foreign bank may locate a representative office. To establish a representative office under the 1991 Representative Office Procedures, foreign financial institutions must complete a three-tiered application process. First, a foreign investor must submit an application to the local branch of the PBOC.⁷¹ Second, if the PBOC accepts this initial application, it will issue an official application. Third, if the PBOC approves this official application, it will issue a certificate of approval, and agents of the representative office must subsequently register with the local branches of the PBOC, the Department of Industry and Commerce, the Public Security Bureau, and the tax authorities.⁷²

5. Dissolution of a Representative Office

If a foreign bank seeks to close a representative office, it must apply to the PBOC and undergo a process of "deregistration." The regulations, however, fail to provide any details about the nature of this process.⁷³ To date, Citibank is the only foreign bank to have closed an office in China.⁷⁴

B. Foreign Bank Branches⁷⁵

While representative offices remain a valuable means of gaining a foothold in China, the combination of new regulations, China's booming economy, and the preclusion of representative offices from most

71. Id. art. 5. A copy of a foreign business license, articles of association, and annual reports for the three years preceding the request must accompany the application. Id.

72. Id. art. 7.

73. 1991 Representative Office Procedures, *supra* note 49, art. 15.

74. See Jonathan Burton, Most US Banks in China Are Open, But 'It's Not Business as Usual,' *Am. Banker*, June 7, 1989, at 1 (explaining that in the wake of the Tiananmen Square incident, Citibank closed up shop and other banks adopted a "wait and see" attitude).

75. For the purposes of this article, the term "foreign bank branch" will encompass both traditional branches and *head office* branches. Occasional differences between *head office* branches and regular branches will be noted. There has been no interpretation or description of the term *head office* branch. The author assumes that a *head office branch* is a branch of a foreign banking institution that serves as the nucleus of the bank's Chinese or regional banking activities. See Fung *supra* note 5, at 20; Lisa Jane O'Neil, Pressure on Industry to Change, *S. China Morning Post*, Oct. 16, 1993 (Supp.), at 33 (description of Citibank's new head office branch).

profitable banking activities has attracted record numbers of foreign bankers to explore instead the possibilities of establishing bank branches in China.⁷⁶

1. Legal Framework

The legal framework surrounding foreign bank branches is a patchwork of central government, PBOC, and local regulations. As a result, foreign bank branches located in different parts of the country are subject to different regulatory schemes.⁷⁷

a. Special Economic Zones

The central government's first step toward allowing meaningful foreign participation in China's banking industry was the promulgation in 1985 of the Regulations Governing Foreign Banks and Joint Chinese-Foreign Banks in Special Economic Zones ("1985 SEZ Foreign Banking Regulations").⁷⁸ These regulations open China's Special Economic

76. Although recent news reports have heralded the dawn of foreign bank branch activity in China, see, e.g., World - Financing Profiles (Algeria-Japan), Market Reports, May 14, 1993, available in LEXIS, Market Library, Mktprt File. In actuality, foreign banks have been operating branches in the PRC since its formation in 1949, albeit within narrowly prescribed limits. Shanghai branches of Standard Chartered Bank, the Hong Kong & Shanghai Banking Corporation, the Bank of East Asia, and the Chinese Overseas Banking Corporation of Singapore were granted special legal status to remain in China after Mao Zedong founded the People's Republic. More Bank Branches a Boon For Firms Operating in Shanghai, 17 Bus. Int'l 153 (1991); Ron Alpe, Foreign Banks Allowed to Open Branches in SEZs, E. Asian Executive Rep., May 1985, at 11. Prior to the bank reforms of the 1980s, these banks were only permitted to provide such capital and services as the government determined was necessary for China's economic development. Baker, *supra* note 13, at 89; Interview with Anthony Russell, Vice President, Hong Kong & Shanghai Banking Corp., by Pam Baldinger, Editor-in-Chief, China Business Review, in Washington, D.C. (Mar. 29, 1993).

77. There are some intimations that this will change sometime in the near future. According to sources at the PBOC, the central bank is in the process of drafting a comprehensive banking law which would regulate all foreign banking institutions and consolidate over 760 banking decrees and regulations that have been issued from 1979 to 1990. Liu Weiling, Better Bank Laws on the Drawing Board, China Daily, Sept. 12, 1993 (Business Weekly Supp.), available in LEXIS, World Library, Txtfe File. First Post-1949 Banking Law Being Drafted, China Daily, Sept. 29, 1991 (Business Weekly Supp.), at 1, reprinted in F.B.I.S., Sept. 30, 1991, at 50.

78. Regulations Governing Foreign Banks and Joint Chinese-Foreign Banks in Special Economic Zones of the PRC, art. 2 [hereinafter 1985 SEZ Foreign Banking Regulations], translated in China Econ. News, April 16, 1985, at 2.

Zones ("SEZs")⁷⁹ to foreign bank branch activity and establish the basic parameters for such operations.

The 1985 SEZ Foreign Banking Regulations were supplemented in 1987 by additional regulations issued by the PBOC, the Administration of Special Economic Zone Wholly Owned Foreign Banks and Sino-Foreign Equity Joint Venture Banks Business Tentative Provisions ("1987 SEZ Foreign Banking Administrative Provisions").⁸⁰ The purpose of these PBOC provisions was to "strengthen and improve" the administration and operation of foreign banking institutions in the SEZs by clarifying the earlier central government regulations.⁸¹ In conjunction with the 1985 Foreign Banking Regulations, these PBOC provisions establish the legal framework for foreign bank branching activity in the SEZs.

b. Shanghai

Foreign bank branches in Shanghai are governed by a separate regulatory regime from those in the SEZs⁸². The Administration of Shanghai Foreign Investment Financial Institutions and Sino-Foreign Equity Joint Venture Financial Institution Procedures ("1990 Shanghai Foreign Banking Procedures") allow foreign bank branches to locate

79. The term "Special Economic Zone" refers to one of five zones in the South-East of China designed to lure foreign investment by offering wide latitude in business activities, favorable operating conditions, special land-use rights, streamlined registration measures, tax breaks, and other preferential treatment. Regulations on Special Economic Zones in Guangdong Province, available in WESTLAW, Chinalaw File No. 0019. The five Special Economic Zones in China are Shenzhen, Zhuhai, Shantou, Hainan, and Xiamen. See generally Chen An, *Special Economic Zones and Coastal Port-Cities: Their Development and Legal Framework*, in *Chinese Foreign Economic Law: Analysis and Commentary*, ch. 12 (Rui Mu & Wang Guiguo eds., 1990); Lawrence Reardon, *The SEZs Come of Age*, *China Bus. Rev.*, Nov.-Dec. 1991, at 14.

80. Administration of Special Economic Zone Wholly Owned Foreign Banks and Sino-Foreign Equity Joint Venture Banks Business Tentative Provisions [hereinafter 1987 SEZ Foreign Banking Administrative Provisions], translated in *China L. & Prac.*, Jan. 18, 1988, at 40. These provisions were issued to the SEZ departments of government authorities and were never promulgated or publicly announced. See also Editor's Notes, *China L. & Prac.*, Jan. 1, 1988, at 46.

81. 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, at pmbl.

82. Before 1949, Shanghai was the financial heart of Asia. In an effort to recover some of this past glory, the Chinese central government targeted Shanghai for accelerated development, starting in 1990.

anywhere in the Shanghai municipal area⁸³ and to engage in essentially the same activities permitted in the SEZs.⁸⁴

c. Newly Opened Cities

In addition to Shanghai and the SEZs, foreign branch activity has been authorized by the PBOC in seven other cities, specifically Guangzhou, Dalian, Tianjin, Qingdao, Ningbo, Nanjing, and Fuzhou.⁸⁵ It remains unclear whether or not branches in these cities will be able to expand their scope of business beyond that permitted in Shanghai and the SEZs, as no guidelines have yet been established to regulate foreign banks in these areas.⁸⁶ Until local officials draft their own legislation or the PBOC adopts national regulations, foreign bankers have been informed merely that the 1990 Shanghai Foreign Banking Procedures should serve as a framework.⁸⁷

2. Functions of Foreign Bank Branches

Under both the SEZ and Shanghai regulations, foreign bank branches are permitted to take deposits, make loans, extend trade services, and underwrite securities offerings. All of these activities, however, are subject to extensive limitations, reflecting the government's fear that foreign banks may try to manipulate the economy. This section attempts to catalog the types of services that foreign bank branches are sanctioned to provide and to review the restrictions attendant to their operations.

83. Administration of Shanghai Foreign Investment Financial Institutions and Sino-Foreign Equity Joint Venture Financial Institution Procedures in 1990, art. 1 [hereinafter 1990 Shanghai Foreign Banking Procedures], translated in *China Banking & Fin.*, Oct. 1, 1990, at 8 (part one), *China Banking & Fin.*, Nov. 5, 1990, at 6 (part two).

84. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 20. See also 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 6; Rafferty, *supra* note 57, at 153.

85. Ren Kan, Foreign Banks Plan to Grow Branch Network, *China Daily*, Aug. 30, 1992 (*Business Weekly Supp.*), at 1, reprinted in *F.B.I.S.*, Aug. 31, 1992, at 35; Sender, *supra* note 19, at 62.

86. Foreign Bank Branches in Guangzhou, (Aug. 12, 1992) (unpublished manuscript, American Consulate, Guangzhou China, on file with author).

87. Interview with James Heimowitz, Vice President, Chase Manhattan Bank, in Washington, D.C. (Jan. 17, 1993).

a. *Deposits and Loans*

Foreign bank branches in Shanghai and the SEZs are authorized both to accept deposits and to grant loans. However, such business is also circumscribed by numerous limitations on the types of currency, clients, or interest rates which may be associated with any transaction.

i. *Foreign Exchange Transactions*

For the past decade, the PBOC has restricted foreign bank branches to accepting deposits and extending loans exclusively in foreign currency.⁸⁸ The 1990 Shanghai Foreign Banking Procedures explicitly authorize foreign bank deposit and loan activity only in foreign exchange.⁸⁹ The 1985 and 1987 SEZ regulations, while permitting foreign bank branches to accept deposits and grant loans in both local and foreign currency, require that such transactions be subject to the approval of the PBOC, and the PBOC has consistently balked at approving transactions involving *renminbi*.⁹⁰

88. See People's Bank Restricts Foreign Bank Activities, *supra* note 59, at 2; Anne A. LeBourgeois & Stephen K.F. Chung, *Commercial Banks in China: Economic Plans are Creating Opportunities*, *China Bus. Rev.*, Jan.-Feb. 1986, at 25.

In May 1988, the PBOC permitted two foreign bank branches to engage in *renminbi* transactions on a trial basis. The 1990 PBOC Circular revoked this new-found freedom. *Foreign Banks Allowed to Do Renminbi Business*, *Xinhua General Overseas Service*, May 16, 1988, translated in *F.B.I.S.*, June 22, 1988, at 29; *People's Bank Restricts Foreign Bank Activities*, *supra* note 59, at 2.

89. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 20. Under the Shanghai regulations, the possibility of entering the *renminbi* market could fall under the catch-all phrase "other approved forms of business". *Id.*

90. Before January 1, 1994, China had two currency systems. *Renminbi* was, and is literally, the "people's currency". It was originally restricted to use by Chinese citizens and was inconvertible, although sanctioned swap centers were set up in most major cities. Introduced in 1980, Foreign Exchange Certificates ("FEC") were used by foreign investment enterprises, tourists, and other non-Chinese entities, and were convertible into foreign exchange. See Tideman, *supra* note 32, at 17. One US dollar is approximately equal to RMB 8.5.

As of January 1, 1994, the PBOC abolished the official rate of the *renminbi* and made it convertible, pegging it to the floating swap center rates. *China's Foreign Exchange Benefits Hong Kong*, *Xinhua General Overseas Service*, Jan. 31, 1993, available in LEXIS, World Library, Txtfe File. Further, the government has started buying back FEC in a move to gradually withdraw this currency from circulation. Ren Kan, *China: No Swaps in Buying Back FECs*, *China Daily*, Jan. 30, 1994 (*Business Weekly Supp.*), available in LEXIS, World Library, Txtfe File.

In recent months, however, there have been indications that Chinese policy in this area may be changing.⁹¹ On January 21, 1994, China's Finance Minister, Liu Zhongli, announced that "some" foreign banks will be permitted to accept deposits in Chinese currency.⁹² Although it remains to be seen which foreign banks will be authorized to engage in *renminbi* transactions and in what cities, such a move would constitute a significant step in the opening of China's financial sector.⁹³

ii. Interest Rates

Under the 1985 SEZ Foreign Banking Regulations, all interest rates offered by foreign banks on deposits and loans in an SEZ must conform to rates prescribed by the PBOC branch for that SEZ.⁹⁴ Similarly, in Shanghai, under the 1990 Shanghai Foreign Banking Procedures, interest rates offered by foreign banks must have prior PBOC approval.⁹⁵

To further reinforce its control over interest rates, the PBOC issued the Administration of Interest Rates Provisions in 1991 to regulate bank activity in all parts of China.⁹⁶ These provisions require that all interest rates be approved by the PBOC "at the appropriate level."⁹⁷ Further, they delegate responsibility to the "head office of the PBOC"

91. The PBOC has recently approved opening the *renminbi* market to foreign banks on a limited and experimental basis. Thomas L. Friedman, *Bank Rules Are Eased by China: Foreign Institutions to Get More Access*, N.Y. Times, Jan. 22, 1994, at A37.

92. See *supra* note 91.

93. Regardless of any change to the regulatory landscape in China, foreign bank branches have found several ways to circumvent currency restrictions. For example, foreign banks have been able to accept *renminbi* deposits as agents of the Industrial and Commercial Bank of China. *More Bank Branches a Boon for Firms Operating in Shanghai*, *supra* note 76, at 154. See also LeBourgeois & Chung, *supra* note 88, at 28. In terms of satisfying clients' needs for credit in the local currency, branches have acted as go-betweens, helping clients arrange such credit through local financial institutions. *More Bank Branches a Boon for Firms Operating in Shanghai*, *supra* note 76, at 155. Alternatively, branches have provided clients with foreign currency loans which clients are then able to exchange with the Bank of China for *renminbi*. *Id.* at 155.

94. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 10.

95. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 33. The Shanghai Procedures actually seem to contemplate the existence of a "Bankers' Association," which would set rates for foreign banks subject to PBOC approval. However, the procedures do not offer any information about this organization, nor has such an association been mentioned in news releases from Shanghai or by foreign banks operating in that city.

96. New Banking and Finance Regulations, China Banking & Fin., Mar. 4, 1991, at 6, 8.

97. *Id.*

for establishing interest rate levels for "late payments" and for penalties imposed on funds diverted to "other than intended uses."⁹⁸

The PBOC's control over interest rates on both deposits and loans has made it difficult for foreign bankers to lend money at profitable rates.⁹⁹ In past years, it has been common for gross margins to fall below ½%.¹⁰⁰ In addition, loan agreements are often subject to unforeseeable, last-minute costs which, in conjunction with PBOC interest rate restrictions, drive profits down even further.¹⁰¹ In a recent about-face, however, the PBOC has become more lenient with regard to interest rates, and foreign bankers have been able to introduce their own differentials.¹⁰²

iii. Clients

Along with restrictions on the scope of foreign bank activities, the 1985 and 1987 SEZ provisions also regulate the types of clients that foreign banks may serve. For deposits of foreign currency, branches may only deal with overseas Chinese individuals and enterprises, foreign investment enterprises ("FIEs"), foreign individuals, and other banks.¹⁰³ For foreign currency loans, branches must deal exclusively with FIEs, state-owned or collective enterprises, enterprises outside of the PRC, and other banks. Under the SEZ provisions, branches are expressly prohibited from accepting deposits from or making loans to private enterprises or Chinese individuals.¹⁰⁴

The 1990 Shanghai Foreign Banking Procedures also restrict the types of customers available to foreign bank branches. However, the

98. *Id.*

99. See Gerard, *supra* note 15, at 26.

100. See *id.*

101. See *id.* (explaining that foreign bankers can face eleventh-hour demands to cover the living and travel expenses of Chinese trainees sent overseas and demands to cover hotel tabs for sixty-plus guests invited by the Chinese party).

102. See Tony Shale, *Foreign Banks Scramble to Win Chinese Business*, Reuter Textline: Euromoney, Aug. 1, 1993, available in LEXIS, News Library, Txtnews File.

103. 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 2(i); 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 6. See also LeBourgeois & Chung, *supra* note 88, at 28; A Wider Door for Foreign Banks to China, *China Econ. News*, May 18, 1992, at 1. Foreign experts are teachers, engineers, or other specialists with whom the Chinese government has short-term contracts.

104. By spelling out the clients that foreign bank branches are permitted to serve, the regulations clearly indicate the borrowers and depositors that are off-limits. See 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 2(i).

Shanghai procedures are not as limiting as the SEZ regulations. Under the Shanghai regulations, branches may accept deposits from or make loans to either foreign or Chinese clients, subject to PBOC approval.¹⁰⁵ The one exception remains import and export settlement, where foreign bankers are limited to serving FIEs and authorized Chinese investment enterprises.¹⁰⁶

In practice, foreign bank branches lend primarily to FIEs, the Bank of China, CITIC, regional international trust and investment corporations, the Bank of Communications, and a few large state corporations which provide goods for export.¹⁰⁷

b. Trade Services

Foreign bank branches in China are authorized to provide a number of trade services, including the issuance of letters of credit and processing of documents for export and import transactions.¹⁰⁸ However, as with deposits and loans, there are regulatory limits on the types of clients that banks may accept.

Under the 1987 SEZ Foreign Banking Administrative Provisions, foreign bank branches may handle remittances in payment for goods *exported from China* regardless of the identity of the seller.¹⁰⁹ By contrast, foreign bank branches may only handle remittances in payment for goods *imported into China* if the purchaser of the goods is an FIE.¹¹⁰ And in cases of import/export transactions where a foreign bank will collect commercial paper, issue letters of credit, or confirm letters of credit, the client must be either an FIE or a domestic

105. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 20.

106. *Id.* art. 23.

107. Gerard, *supra* note 15, at 25. While this client base has remained fairly constant over the years, the types of projects funded have changed. In the early and mid-1980s, most foreign bank loans went to hotel construction projects. Now, foreign banks are supplying working capital and funds for industrial, transportation, and real estate development. Ipson, *supra* note 17, at 5.

108. See Robert C.H. Lee, *Legal Aspects of Foreign Banking in China, Doing Business in China* (William P. Strong & Allen B. Wilcox, eds., 1992); Gerard, *supra* note 15, at 24.

109. If remittance is to a domestic Chinese enterprise for the export of goods, all foreign currency must be transferred to the PBOC branch office for the SEZ. 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 8(i)(a). If remittance is to an FIE or other foreign entity, then the client may choose either to keep any foreign currency or exchange it for *renminbi*. If foreign currency is exchanged for *renminbi*, then the foreign currency must be transferred to the PBOC branch office for the SEZ after settlement of the exchange. *Id.* para. 8(i)(b).

110. 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 8(ii).

enterprise sanctioned by the local SAEC branch office.¹¹¹ The 1990 Shanghai Foreign Banking Procedures do not contain such restrictions on foreign trade remittances.

Beyond the legal limitations on a foreign bank's trade service business, there are other potential obstacles of which a foreign banker should be aware, specifically with regard to letters of credit. In the past, foreign branches have faced problems handling letters of credit because of difficulties in getting them open on time, in ensuring their conformity with underlying contracts, and in arranging the issuance of associated negotiable bills.¹¹² Additionally, because shipments are often delayed pending receipt of amendments to these letters, it is not unusual for a credit agreement to expire before the documents have been presented.¹¹³

c. *Securities Underwriting*

Reports of flourishing stock markets in Shanghai and Shenzhen and the absence of legislation like Glass-Steagall to separate commercial banking from securities activities have captured the attention of more than a few foreign bankers.¹¹⁴ Further, the emergence of "B shares," denominated in *renminbi* but sold to foreigners with dividends and profits that may be remitted abroad, on both the Shanghai and the Shenzhen securities exchanges, has created a demand for securities underwriting by foreign banks.¹¹⁵ Completing the mix, foreign bank branches in Shanghai have been authorized to serve as custodian banks for B shares traded on the Shanghai exchange. Foreign banks without branches in Shanghai "may commission these custodian banks."¹¹⁶

111. Id. para. 9(i); Cf. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 23.

112. See LeBourgeois & Chung, *supra* note 88, at 2; Christopher Smith & D. S. Cheung, L/C and Guarantee Defaults-Pitfalls to Avoid, *China Banking & Fin.*, Apr. 9, 1990, at 2.

113. Smith & Cheung, *supra* note 112, at 2.

114. Cf. Lincoln Kaye & Elizabeth Cheng, *Babes in the Bourse: China Embarks on its Most Daring Economic Experiment. Will Socialism Survive?*, *Far E. Econ. Rev.*, July 16, 1992, at 48; Julia W. Sze, *The Allure of B Shares*, *China Bus. Rev.*, Jan.-Feb. 1993, at 42. But see Andrew Browne, *Western Love Affair with China Stocks Turns Sour*, *Reuters*, Aug. 5, 1993, available in LEXIS, World Library, Txtwns File.

115. See generally Pitman B. Potter, *Securities Markets Opening to Foreign Participation*, *E. Asian Executive Rep.*, Apr. 1992, at 7; Julia Leung, *Foreign Banks Renew Interest in China, Ending Hiatus After Tiananmen Uproar*, *Wall St. J.*, Aug. 4, 1992, at A7.

116. Shanghai Securities Exchange, *B Share Custody Bank Tentative Procedures*, art. 1, translated in *China Banking & Fin.*, Oct. 9, 1992, at 1.

However, the allure of the new stock exchanges is coupled with adversity. Chinese accounting methods fail to conform to generally accepted world standards and Chinese exchanges are plagued by reports of corruption, insider-trading, and other abuses.¹¹⁷ For banks engaging in custodial services, regulations may make such services extremely costly, as fees are charged for all materials provided by the Shanghai exchange and there are harsh penalties for violations of trading orders.¹¹⁸

In general, foreign banks have largely accepted these problems in their eagerness to get in on the ground floor. The Hong Kong and Shanghai Banking Corporation and CCIC Finance, an affiliate of The First National Bank of Chicago, Ltd., are already underwriting stocks and serving as custodian banks.¹¹⁹ Many other banks have followed suit and have submitted underwriting bids in both Shanghai and Shenzhen.¹²⁰

3. Provisions to Ensure Liquidity

Foreign banks that engage in lending, trade services, and securities underwriting are increasingly witnessing favorable returns on capital.¹²¹ Their ability to take full advantage of profits, however, has been frustrated by requirements under SEZ and Shanghai banking regulations aimed at ensuring liquidity.

According to SEZ and Shanghai banking regulations, all foreign bank branches are required to maintain non-interest bearing reserve accounts with the PBOC.¹²² For foreign bank branches located in the SEZs, the deposit/reserve ratio is purportedly calculated in accordance with a formula described in the 1987 SEZ Foreign Banking

117. See Potter, *supra* note 115, at 7.

118. *Id.* art. 17.

119. Interview with Anthony Russell, *supra* note 76; Interview with David Warner, *supra* note 8.

120. See Sze, *supra* note 114, at 44 (describing the joint efforts of domestic securities companies and foreign underwriters to place B shares).

121. See Shale, *supra* note 102.

122. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 11; 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 3; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 24. Head office branches and joint ventures are also required to make numerous payments (for taxes, employee benefits, reserve fund requirements, etc.) before any profits leave the country. See 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 14.

Administrative Provisions.¹²³ However, a PBOC circular issued in June 1990 has apparently superseded the formula found in these provisions, establishing a 6% reserve ratio for all foreign bank branches located in SEZs.¹²⁴

Although the PBOC circular only refers to banks in the Special Economic Zones, it probably also applies to branches in Shanghai. Article 24 of the 1990 Shanghai Foreign Banking Procedures stipulates that deposit/reserve ratios for the municipality are to be set by the PBOC.¹²⁵

Reserve ratios are not the only regulatory scheme designed to encourage liquidity. SEZ and Shanghai banking regulations impose limitations on repatriation of profits. In Shanghai, a foreign bank branch must retain 25% of all after-tax profits in the People's Republic until the branch's profits equal the amount of its working capital.¹²⁶ In the SEZs this requirement only applies to head office branches, but there is no provision for graduation.¹²⁷

In addition to reserve requirements and limits on repatriation of profits, Shanghai branches must deposit 30% of their working capital in interest-bearing accounts with the PBOC.¹²⁸ Head office branches in Shanghai must additionally ensure that neither loans nor investments exceed 30% of registered capital and that real estate holdings do not exceed 25% of registered capital.¹²⁹ Requirements for head office branches in the SEZs are only slightly different from those in Shanghai. Like their counterparts in Shanghai, SEZ head office branches must observe a 30% cap on loans or investments. However, unlike in

123. Under the formula for calculating reserve ratios in the 1987 SEZ Foreign Banking Administrative Provisions, foreign bank branch reserves must equal "the average monthly balance of the total amount of foreign currency deposits" times "the deposit reserve rate." The term "average monthly balance of the total amount of foreign currency deposits" is defined as "the aggregate total of foreign currency deposits from the first day of each month divided by the number of days in that month." 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 3.

124. People's Bank Restricts Foreign Bank Activities, *supra* note 59, at 2.

125. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 24.

126. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 19. Head office branches and joint-venture banks must hold 25% of all profits in China until the sum of their reserves and paid-up capital reaches two times the amount of their registered capital. *Id.*

127. 1987 SEZ Foreign Banking Provisions, *supra* note 80, para. 7.

128. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, arts. 28, 30.

129. *Id.* arts. 25, 26, 29.

Shanghai, head office branches in the SEZs must also maintain 25% of all deposits in liquid assets.¹³⁰

These liquidity requirements have driven down interest rates and encouraged FIEs to deposit their money outside of China. As a consequence, the liquidity requirements of the SEZs and Shanghai have also caused branches to suffer significant opportunity costs. Unfortunately, there is no indication that these restrictions will be lifted in the near future.

4. Disclosure Requirements and Failure to Comply

In both the SEZs and Shanghai, foreign bank branches are subject to certain disclosure requirements. In the SEZs, regulations require monthly submissions of balance sheets and financial reports to the PBOC; and in Shanghai, the regulations stipulate, somewhat opaquely, that balance sheets and financial reports must be provided to the PBOC "in accordance with regulations."¹³¹ Under both regulatory schemes, all auditing must be performed by accountants registered in the People's Republic.¹³² The PBOC retains the power to demand further information from banks and reserves the right to send appointed officers to investigate a bank's operations.¹³³

In cases where a foreign bank branch does not observe the disclosure requirements described above, the SEZ and Shanghai regulations empower PBOC branch offices "to issue a warning or impose a fine" on the offending branch.¹³⁴ In the Special Economic Zones, neither the 1985 SEZ Foreign Banking Regulations nor the 1987 SEZ Foreign Banking Administrative Provisions enumerates the types of acts that might constitute nonobservance of disclosure requirements. Nor do the SEZ regulations stipulate with any specificity the penalties for failure to make proper disclosure; they merely suggest that the

130 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 9; 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, paras. 1(ii), 4, 5, 6, 7.

131. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 12; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 38.

132. 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 13; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 36.

133. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 13; 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 14; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 39.

134. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 16; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, arts. 45-48.

penalties must fit the crimes and that the PBOC has the power to force the closing or dissolution of a branch.¹³⁵

The 1990 Shanghai Foreign Banking Procedures, on the other hand, articulate specific violations as well as corresponding penalties. If a foreign bank opens a branch without proper authorization or exceeds its approved scope of business, it may face closure, confiscation of unlawful income, and fines of up to RMB 50,000;¹³⁶ foreign banks violating regulatory requirements with regards to the administration of business activities are subject to a fine of up to RMB 30,000;¹³⁷ and failing to submit reports to the PBOC on time or resisting inspection proceedings can result in fines from RMB 3,000 to RMB 10,000.¹³⁸

When saddled with excessive or unfair penalties, foreign bank branches are not without legal recourse. As described above, foreign bank branches subjected to fines or penalties by an administrative organ of government can appeal the decision under the Regulations on Reconsideration of Administrative Measures.¹³⁹

It is worth nothing that as of yet there are no published cases of fines or penalties being levied against foreign bank branches. This is not to say that there are no banks that have been the subject of punitive measures, but the Chinese are loathe to kick a gift horse in the mouth. Foreign bank branches provide valuable foreign currency and serve as magnets to attract FIEs to China. Officials in Beijing and the municipalities are perhaps more concerned with courting foreign banks and have spent the past few years wining and dining foreign bankers and amending regulations to attract increased foreign involvement in the Chinese banking sector.¹⁴⁰

135. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 16. See also 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 15 (stating that a PBOC branch can issue oral and written warnings and "impose sanctions" for violations against the provisions).

136. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, arts. 45-46.

137. *Id.* art. 47.

138. *Id.* art. 48.

139. Regulations on Reconsideration of Administrative Measures, *supra* note 66; See also discussion *supra* Section III(A)(3).

140. See Taste of China Market from Dinner with Zhu, *S. China Morning Post*, Nov. 12, 1993 (Business), at 16.

5. Establishing a Foreign Bank Branch

In accordance with SEZ banking regulations, a foreign bank proposing to open an office in an SEZ should submit an application to the PBOC.¹⁴¹ If the PBOC approves the application, the bank has thirty days to deposit foreign currency operating funds equivalent to RMB 40 million at the PBOC branch for the relevant SEZ as operating funds.¹⁴²

A foreign bank planning to set up a branch in Shanghai is subjected to a slightly different application process. Initially, the foreign bank must establish that it had assets totalling US\$20 million at the end of the year preceding its application, has operated a representative office in China for over three years, and is willing to provide US\$10 million in registered capital for its contemplated branch.¹⁴³ The actual application process involves two steps. First, the foreign bank must submit an *unofficial* application form to the PBOC.¹⁴⁴ Second, after PBOC initially approves the bank's unofficial application, the bank must complete an *official* application form.¹⁴⁵

Although the two-prong application process for branches in Shanghai appears to create an additional barrier to foreign investment in the city, many foreign bankers have found the Shanghai authorities to be more welcoming and accommodating than their counterparts in the

141. 1985 SEZ Foreign Banking Regulations, *supra* note 78, arts. 4, 5(IV). The 1985 SEZ Foreign Banking Regulations also list required contents for an application. *Id.* arts. 5(I)(1)-(4).

142. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 7; 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 1(i). Head office branches must deposit foreign currency equivalent to eighty million RMB. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 7. The PBOC branches verify the receipt of such funds and can sanction their deposit in banks outside of China. *Id.*

143. *Id.* arts. 5, 17. The head office branch must have assets of US \$10 million at the end of the year preceding its application. *Id.* art. 5. Cf. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 7.

144. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 9. This unofficial application is similar in its requirements to an application for an SEZ branch. However, the initial requirements for establishment of a head office branch of a foreign bank are considerably more stringent. See *id.* art. 8.

145. *Id.* art. 12. The regulations state that "[a]fter filling out the official application, the applicant shall make an official application with the People's Bank of China" and include the application form, brief history and powers of attorney for the people in charge of the branch, a guarantee from the head office for taxes and debts of the branch, and "other materials." *Id.*

SEZs.¹⁴⁶ And while the SEZs benefit from their close proximity to investment-hungry Hong Kong and Taiwan,¹⁴⁷ Beijing officials and foreign entrepreneurs alike are touting Shanghai as the future financial and industrial center of China.¹⁴⁸

6. Dissolution of a Foreign Bank Branch

Under SEZ and Shanghai banking regulations, thirty days before a foreign bank branch plans to dissolve its operations in China, it must submit an application to the PBOC for approval.¹⁴⁹ When dissolution is approved, the branch is liquidated, and after satisfaction of all taxes and liabilities, funds may be remitted abroad.¹⁵⁰

Citicorp is the only foreign bank to have dissolved an office in China, closing its representative office in Beijing in the aftermath of Tiananmen.¹⁵¹ Since there has never been a voluntary dissolution of a branch in either Shanghai or the SEZs,¹⁵² provisions for voluntary dissolution under Shanghai and SEZ banking regulations remain untested.¹⁵³

Most foreign banks have positioned themselves in China for the long haul and are willing to accept the limitations of China's financial

146. See generally Shanghai: Really That Good?, *Economist* (Business China Supp.), Autumn 1993, at 1, 1-2. See also Diane Francis, All Roads, Rivers Lead to Shanghai, *Fin. Post*, Mar. 4, 1993, at 13.

147. See generally Taiwanese Companies Devise Clever Ways to Invest in the PRC, *Business International: Business China*, Aug. 12, 1991, available in LEXIS, News Library, Buchin File.

148. See Francis, *supra* note 146, at 13; US, Hong Kong Show the Way to Money Men, *China Daily*, Sept. 19, 1993 (Business Weekly Supp.), available in LEXIS, News Library, Txprim File (quoting executives from Squibb Pharmaceutical and Johnson & Johnson, Inc.).

149. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 15; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 40. See also discussion *supra* Section III(A)(5).

150. 1985 Foreign Banking Regulations, *supra* note 78, art. 15; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, arts. 42, 43.

151. Burton, *supra* note 74, at 1. Despite closing its Beijing office, Citicorp continued to maintain offices in Shanghai and Shenzhen. *Id.*

152. The only case involving the dissolution of a foreign bank branch in China was the forced liquidation of the Bank of Commerce and Credit International in the wake of the scandals of 1991. Unfortunately, very little information is available on this case. See *Directory: Financial Institutions, China Banking & Fin.*, Aug. 26, 1991, at 14.

153. *Id.* If the 1991 forced liquidation of the Bank of Commerce and Credit International branch in Shenzhen is any indication, then SEZ and Shanghai regulations accurately describe likely proceedings in the event of a voluntary dissolution. The PBOC appointed liquidators that compiled a report on assets and liabilities and paid the branch's outstanding debts. *Id.* at 13.

regulations and the possibility of sustaining losses in the short term for the sake of early entry into China's growing financial markets.¹⁵⁴

C. *Joint Venture Banks*

Although joint venture banks are similar to branch offices, as both are subject to much the same regulatory framework, joint venture banks also manifest their own unique advantages and disadvantages. For investors searching for an alternative means of penetrating China's vast financial market, these differences make the joint venture bank a viable alternative to the bank branch.¹⁵⁵

1. Legal Framework

Like foreign bank branches, joint venture banks are governed by the 1985 SEZ Foreign Banking Regulations, the 1987 SEZ Foreign Banking Administrative Provisions, and the 1990 Shanghai Foreign Banking Procedures.¹⁵⁶ Consequently, joint venture banks must observe many of the same regulatory requirements as foreign bank branches. Specifically, joint venture banks are subject to the same requirements for dissolution and inspection.¹⁵⁷ However, the SEZ and Shanghai regulations also impose restrictions and create opportunities for joint venture banks that are distinct from those imposed on and created for bank branches.

154. See Geoff Crothall, Bankers to Check Out Shanghai, *S. China Morning Post*, Oct. 1, 1990, at 1; Fung, *supra* note 5, at 20.

155. To date, only three joint venture banks have opened for business in China. In Xiamen, the following investors have combined to form the Xiamen International Bank: Min Xin Holdings, Ltd. of Hong Kong, the Asian Development Bank, the Long-Term Credit Bank of Japan, Ltd., the Sino Finance Group, Ltd. of Hawaii, the Fujian branch of the Industrial and Commercial Bank of China, the Fujian Investment and Enterprise Corporation, and the Construction Corporation of Xiamen. In Shanghai, the Shanghai branch of the Industrial and Commercial Bank of China joined forces with the Banque Nationale de Paris to establish the International Bank of Shanghai and Paris. And in Shenzhen, the Shenzhen branch of the Industrial and Commercial Bank of China, the Chinese Travel Service, and Hong Kong-Chinese Bank have opened a third joint venture bank.

156. See discussion *supra* III(B)(1).

157. See 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 2; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 2.

2. Functions of Joint Venture Banks

Joint venture banks enjoy the same scope of business activities as foreign bank branches, with one exception.¹⁵⁸ Joint ventures established in the SEZs must receive PBOC approval before handling certain types of remittances to destinations outside of China.¹⁵⁹ The specific cases where approval is required are as follows: capital transfers, transfers of foreign exchange funds allotted to foreign parties after liquidation, and transfers of income for foreign employees.¹⁶⁰

Although the business opportunities open to joint ventures and bank branches are almost identical on paper, in practice joint ventures are uniquely positioned to capitalize on the Chinese market. Through its Chinese partner, a joint venture may have access to an established client base,¹⁶¹ insider information about the Chinese banking sector,¹⁶² and contacts within the government.¹⁶³ These factors allow joint ventures to tap a broader market for their services than normally available to foreign banks in China. Specifically, joint ventures can expand their lending business beyond FIEs and large domestic corporations to encompass even medium-sized domestic companies; and joint ventures enjoy a greater measure of freedom to branch within China.¹⁶⁴

3. Provisions to Ensure Liquidity

Joint venture banks, like foreign bank branches, are subject to a series of regulatory requirements intended to ensure liquidity. First, joint ventures must maintain approximately US\$10 million in registered capital in the SEZs and US\$30 million in Shanghai.¹⁶⁵ Second, they must observe a cap on lending and investment; neither may exceed 30%

158. See discussion *supra* III(B)(2).

159. 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 8(ii)(a)-(c).

160. *Id.* It is important to note that there are no similar restrictions applicable in Shanghai.

161. See Zheng, *supra* note 56, at 449.

162. See generally Zheng, *supra* note 56, at 449; Over the Real Chinese Wall, *Economist*, Apr. 29, 1991, at 84, 84.

163. See generally Over the Real Chinese Wall, *supra* note 162, at 84.

164. *Id.*

165. 1985 SEZ Foreign Banking Regulations, *supra* note 78, at art. 7 (registered capital requirement of RMB 80 million); 1990 Shanghai Foreign Banking Procedures, *supra* note 83, at arts. 6, 7.

of a bank's registered capital and reserves.¹⁶⁶ Third, joint ventures must maintain 25% of all after-tax profits in an account with the PBOC in accordance with a formula specified in the 1987 SEZ Foreign Banking Administrative Provisions.¹⁶⁷ In Shanghai, joint ventures may "graduate" from this 25% requirement when "reserves and registered capital equal two times registered capital".¹⁶⁸ In the SEZs, there is no similar graduation provision. Fourth, before remitting profits abroad, SEZ and Shanghai banking regulations require joint ventures to create and maintain a set of specialized reserve funds.¹⁶⁹ These include an employee fund, a welfare fund, and an enterprise development fund.¹⁷⁰

4. Disclosure Requirements and Failure to Comply

Joint venture banks share the same disclosure requirements and penalties for noncompliance as foreign bank branches.¹⁷¹

5. Establishing a Joint Venture Bank

Joint venture banks must meet substantial registered capital requirements. In Shanghai, parties to a joint venture must establish at least US\$30 million in initial registered capital.¹⁷² In the SEZs, the initial registered capital requirement is RMB 80 million, no less than half of which amount must be paid-in capital.¹⁷³

In addition to capital requirements, under Shanghai banking regulations, each foreign investor in a joint venture bank must have a representative office in the People's Republic.¹⁷⁴ Furthermore, Shanghai requires that all foreign investors in a joint venture bank must be financial institutions.¹⁷⁵

166. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 9; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, at arts. 25, 26.

167. 1987 SEZ Foreign Banking Administrative Provisions, *supra* note 80, para. 3.

168. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 19.

169. 1985 SEZ Foreign Banking Regulations, *supra* note 78, art. 14; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 34.

170. 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 34.

171. See discussion *supra* Section III(B)(4).

172. See 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 17.

173. *Id.* art. 7.

174. *Id.* To establish a branch in Shanghai, a foreign bank must also have operated a representative office for three years. *Id.*

175. *Id.* arts. 6, 7.

6. Dissolution of a Joint Venture Bank

Joint venture banks share the same procedures for dissolution as foreign bank branches.¹⁷⁶

IV. THE RELATIVE MERITS OF REPRESENTATIVE OFFICES, BANK BRANCHES, AND JOINT VENTURE BANKS

Representative offices, foreign bank branches, and joint venture banks each offer their own benefits and introduce their own unique problems for foreign bankers aspiring to penetrate China's financial market. Foreign banks need to analyze their choice of investment vehicle in light of their specific objectives and requirements.

A. *Representative Offices*

The primary impediment to operating a representative office in China is the prohibition against engaging in profit-making activities.¹⁷⁷ Since 1990, the PBOC has been vigilant about enforcing this restriction and cracking down on offices that offer commercial banking services in violation of the regulations.¹⁷⁸ Representative offices are therefore restricted to conducting consulting, liaison, and market research for the parent bank's offices in other countries.

The limited services offered by representative offices can make them seem an unprofitable proposition. As one U.S. bank chairman commented in 1986, opening a representative office "[i]s an easy way to spend about \$500,000 a year without getting a penny back."¹⁷⁹ However, most foreign bankers today realize that opening a representative office carries tangible benefits. First, a representative office can generate substantial profits for a bank's branches in other countries.¹⁸⁰ It can provide contacts and introductions for overseas bankers and perform promotional and advertising services. Its officers can network with local officials and prospective borrowers and introduce them to bankers from their offices outside of China.

176. See discussion *supra* Section III(B)(6).

177. See Representative Office Procedures, *supra* note 49, art. 8.

178. See Cheung, *supra* note 58, at 76.

179. Rafferty, *supra* 57, at 215 (the article does not identify the author of the quote).

180. See China - Restrictions on Banks, *supra* note 50.

Second, representative offices can provide invaluable information about China's economy, political climate, and new legislation.¹⁸¹ For foreign banks with one or more branches in China, these offices represent an opportunity to acquire knowledge from other regions or municipalities, particularly those in which banks are not yet permitted to branch, such as Beijing. Foreign banks offering lending or trade services without maintaining a branch in China stand to benefit greatly from the insight on conditions in China that a representative office provides.

Third, the formation of a representative office is often necessary before a bank can establish a later presence in China. The Shanghai procedures specifically require that a representative office operate in the city for three years before authorities will consider the placement of either foreign bank branches or joint ventures.¹⁸² Regardless of whether a bank seeks to establish itself in Shanghai, officials in both Beijing and the provinces look much more favorably on foreign banks that have demonstrated a long-term commitment to China.

Foreign bankers continue to open representative offices in record numbers.¹⁸³ To date, well over two hundred foreign bank representative offices have been established in China.¹⁸⁴ Many bankers obviously feel that the benefits of representative offices far outweigh the costs.

B. Foreign Bank Branches

The establishment of a bank branch represents the primary means for foreign banks to penetrate China's commercial banking market. However, in embracing this option, foreign bankers face a host of problems specific to bank branches.

Regulations limiting the scope of branch business present an obvious obstacle to profitable operations. Although selected foreign banks will soon be able to accept *renminbi*, the move is narrow in scope.¹⁸⁵ In addition, the PBOC still restricts these branches' market

181. See Zheng, *supra* note 56, at 456.

182. See 1990 Shanghai Foreign Banking Procedures, *supra* note 83, arts. 5, 6.

183. See, e.g., U.S. Banking Giant to Set Up China Investment Fund, Xinhua Overseas News Service, Nov. 8, 1993, available in LEXIS, World Library, Txtfile File.

184. See World Financing Profiles: China, *supra* note 76.

185. See Friedman, *supra* note 91, at 37.

share by prohibiting them from extending *renminbi* loans.¹⁸⁶ Because the demand for foreign exchange has not grown in proportion to the significant rise in the number of foreign bank branches in the SEZs, Shanghai, and newly opened coastal cities,¹⁸⁷ foreign bankers are relegated to fighting amongst themselves for a share in China's limited foreign exchange markets.¹⁸⁸

Foreign branches also face high levels of unsecured risk. The loan defaults which followed in the wake of Tiananmen opened the eyes of bankers around the world to the shaky foundations for lending in China.¹⁸⁹

Further, if a foreign bank branch is able to make a profit from lending and other commercial banking services, China's liquidity requirements ensure not only that a large percentage of those funds stays in the country but also that a sizable portion remains idle and uninvested.

Even in the face of seemingly insurmountable obstacles, some foreign bank branches are able to operate at a profit, or at least witness returns on capital at "acceptable levels."¹⁹⁰ In fact, hundreds of foreign banks are lining up to try their hand at cracking China's financial market. What can foreign bankers gain today from establishing branches in China? First, the new policy to allow a few banks to accept *renminbi* deposits could be an indication that China will open its *renminbi* market even further to foreign bankers in the near future.¹⁹¹ This would provide access to the savings of approximately 1.2 billion Chinese and to the borrowing needs of thousands of China's enterprises.

Finally, the austerity programs introduced in June 1993 have increased demand for foreign bank loans because the lending practices of domestic institutions have been severely curtailed.¹⁹² In addition,

186. See People's Bank Restricts Foreign Bank Activities, *supra* note 59, at 2; A Wider Door for Foreign Banks to China, *supra* note 103, at 1.

187. See Shale, *supra* note 102; Fung, *supra* note 26, at 5.

188. See Fung, *supra* note 25, at 5.

189. See discussion *infra* Section V.

190. See Shale, *supra* note 102 (quoting Fraser Earle, a group representative at Standard Chartered Bank). According to the Far Eastern Economic Review, only about 25% of all bank branches were operating at a profit in 1990, at the peak of China's austerity campaign. See Cheung, *supra* note 58, at 76. Though the percentage in the black has undoubtedly risen since then, no figures are currently available.

191. See Friedman, *supra* note 91, at 37.

192. See Kent Chen, More Cash Sought from Foreign Banks, *S. China Morning Post*, Nov. 2, 1993 (Business), at 1.

over the last five years, the volume of trade between China and the rest of the world has grown exponentially, swelling the demand for trade services offered by foreign banks.¹⁹³

All of these signs suggest that branches have become an increasingly profitable vehicle for penetrating China's financial market. And foreign bankers have indicated that they want to enter as the market begins to open, to get a jump on the competition and begin developing the *guanxi* and relationships that will make them players in the world's largest economy in the next century.¹⁹⁴

C. Joint Venture Banks

Some Hong Kong and European bankers, however, are exploring the opportunities offered by joint venture banks. Sino-foreign joint venture banks face many of the problems that affect foreign bank branches, in addition to higher capitalization requirements, caps on loans and investment, and stricter liquidity requirements.¹⁹⁵ Further, foreign bankers often have difficulties finding financially sound domestic partners. And even with a reliable partner, conflicts of interest frequently arise, particularly if the Chinese partner has the same line of banking business as the newly-formed joint venture.¹⁹⁶ Most importantly, the foreign parties to a joint venture lose considerable control over the operations of the bank to their domestic partner.¹⁹⁷ This loss of power over the purse-strings serves as a major deterrent to many foreign banks.

While few foreign bankers have as yet become parties to Sino-foreign joint ventures, there are a host of benefits for those who have taken advantage of this alternative to the foreign bank branch. Primarily, foreign banks that are partners in joint ventures have indirect access to the local currency market, since the domestic partner can act as an agent in *renminbi* transactions.¹⁹⁸ In addition, foreign bankers that have established joint ventures have access to a broader client base, an

193. For example, U.S. Exports to China have risen from \$4.8 billion in 1990 to \$7.47 billion in 1992. U.S. imports from China reached \$25.67 billion in 1992, up from \$15.2 in 1990. See *By the Numbers: A Statistical Look at China*, Wall St. J., Dec. 10, 1993, at R12.

194. See Fung, *supra* note 5, at 20.

195. See *supra* Section III(B)(3).

196. See Zheng, *supra* note 56, at 449.

197. Interview with James Heimowitz, *supra* note 87.

198. See Fung, *supra* note 5, at 20.

established banking network, and expertise that is not available to branches.¹⁹⁹ Finally, joint ventures limit the liability of the foreign partner to the amount of its contribution.²⁰⁰

V. LEGAL UNCERTAINTY FACING BANKS: CASE STUDY OF THE LOAN DEFAULTS OF THE LATE 1980s AND SUBSEQUENT FALLOUT

In addition to the difficulties presented by the restrictions on *renminbi* activities, foreign exchange, interest rates, reserve ratios, profits, and working capital, foreign banks, both branches and joint ventures, face other hurdles when lending in China. Although China boasted a reputation as a first-class debtor through most of the 1980s, many problems with its borrowing practices surfaced after June 1989.²⁰¹ This section explores the risks which surfaced after Tiananmen and examines the regulations adopted by the Chinese government in the period up to and following Tiananmen to limit the exposure of foreign banks.

A. *Limitations Revealed*

While the post-Tiananmen loan defaults may be attributed primarily to the factors specific to June 1989, including the flight of foreign capital, high inflation, and austerity programs imposed by the Chinese government, several underlying causes still trouble foreign banks today. These problems fall into two broad categories: (i) judicial enforceability, and (ii) structural problems associated with lending in China arising from Chinese regulations. Under the rubric judicial enforceability, foreign bankers encounter difficulties enforcing guarantees in China, a lack of extraterritorial applicability and enforceability of judgments of friendly judicial forums such as Hong Kong, and unpredictable PRC courts. The regulatory framework extant in June 1989 exacerbated risks by limiting foreign bank access to information and limiting lending opportunities.²⁰²

199. See Noel Fung, *Day of Reckoning Near for Recalcitrant French: Partners Find Way In*, S. China Morning Post, Oct. 14, 1993 (Business), at 18.

200. See Zheng, *supra* note 56, at 459.

201. See Ipson, *supra* note 17. See also Jesse Chang, *Loan Defaults Hurt China*, China Banking & Fin., Aug. 26, 1991, at 2.

202. See Ipson, *supra* note 17, at 2.

1. Limitations on Judicial Enforceability

a. Difficulties Enforcing Guarantees

As most lending in China is unsecured, foreign bankers require guarantees.²⁰³ In the wake of the 1989 loan defaults, however, foreign bankers faced a series of obstacles in their attempts to enforce guarantees. First, prior to 1990, many Chinese enterprises that had issued guarantees were "paper companies", and banks had difficulties forcing these entities to honor their commitments.²⁰⁴ SAEC regulations, such as the Administration of Foreign Exchange Services Engaged in by Designated Foreign Exchange Banks, responded to such concerns and eliminated the emergence of fly-by-night guarantors. Unfortunately, these directives introduced a new set of problems for foreign bankers.²⁰⁵

Second, foreign bankers rarely investigated guarantors, believing that all loans were backed by the full faith and credit of the Chinese government.²⁰⁶ Although in the past government organizations were willing to honor the financial obligations of their subsidiary companies, reforms in the PRC had introduced the principle of "self-responsibility"²⁰⁷ by 1989. Today, guarantors are individually liable for repaying foreign debt when borrowers default.²⁰⁸

Third, the reactions of Chinese guarantors to the loan defaults after Tiananmen were "anything but uniform."²⁰⁹ One guarantor, for instance, repaid all of the debts of the Zhuhai SEZ Development Corporation to the syndicate of foreign banks that had financed the oil joint venture.²¹⁰ This action, however, stands in stark contrast to the

203. See *Lending to China: Banking on the Long Term*, Business International: Business China, Aug. 9, 1993, available in LEXIS, World Library, Allwld File.

204. See Chang, *supra* note 201, at 2. See also Julia Leung, *Guangdong's Decision to Settle Debts of Agency Encourages Foreign Bankers*, Asian Wall St. J. Wkly., Jul. 27, 1992, at 3.

205. See *infra* Section V(B)(1).

206. See Moy, *supra* note 16, at 2.

207. See Leung, *supra* note 204, at 3. See also Gerard, *supra* note 15, at 24.

208. See Gerard, *supra* note 15, at 24; Chang, *supra* note 201, at 4. At some point, however, Beijing may be forced into a position where its image has been so tarnished that it must pay. See Chang, *supra* note 201, at 5.

209. Moy, *supra* note 16, at 3.

210. See *Lloyds Led Syndicate Recovers Nanhai Oil Loan*, China Banking & Fin., Jan. 29, 1990, at 4.

responses of other guarantors that have exhibited hostility, denied liability, or argued that the obligations in question were invalid.²¹¹

Fortunately, provincial governments have recently deviated from the "self-responsibility" philosophy on several occasions and consented to using their own funds to repay debts. Officials in Guangdong, for example, recently agreed to settle the bad debts of a land-owning agency after its guarantor refused to pay.²¹² In this case (the "Guangdong Loan Default Case"), the Guangdong Overseas Chinese Enterprise Corporation had borrowed heavily to build a floating restaurant and a saccharine plant.²¹³ While the Guangdong municipality agreed to pay 50% of the exposure to The First National Bank of Chicago, Standard Chartered Bank, and the Hong Kong & Shanghai Banking Corporation, another of the creditors, Mitsubishi Bank Ltd., was never repaid.²¹⁴ Foreign bankers should be aware of the difficulties in determining whether their borrowers are likely to receive full state support.²¹⁵ It is also unclear whether Guangdong or other provinces will follow this example in the future.

The Guangdong Loan Default Case illustrates a final problem that arises when foreign banks seek repayment from guarantors on foreign loans. At the time that the loans were made, the land-owning company was under the direct control of the Overseas Chinese Affairs Office, an entity that had access to foreign exchange. When the company began to default on its loans, however, it had come under the supervision of the Agricultural Commission.²¹⁶ Such shifts in supervisory authority effectively transform the identity of the borrower and can be devastating for foreign banks.

211. See Moy, *supra* note 16, at 4.

212. Leung, *supra* note 204, at 3. See also First Chicago in Floating Restaurant Sale, *China Banking & Fin.*, May 20, 1991, at 8. Note that this guarantor, like many in the pre-Tiananmen era, was not sanctioned by the SAEC. See *infra* Section V(B)(2).

213. First Chicago in Floating Restaurant Sale, *supra* note 212. The floating restaurant project fell apart after local authorities refused to grant permission to operate the vehicle on the Pearl River. *Id.*

214. Leung, *supra* note 204, at 3.

215. See Gerard, *supra* note 15, at 24.

216. First Chicago in Floating Restaurant Sale, *supra* note 212, at 8.

b. Filing Suit in Hong Kong

The lenders in the Guangdong Loan Default Case began to redress their grievance by bringing legal action in a Hong Kong court.²¹⁷ Hong Kong courts could exercise jurisdiction because one of the parties to the joint venture debtor was a Hong Kong company.²¹⁸ Many other foreign bankers faced with loan defaults where one of the parties involved is a Hong Kong individual or enterprise have followed suit and taken guarantors to court in the British colony near Guangdong.²¹⁹ In most recent cases, Hong Kong courts have responded with judgments against Chinese guarantors but have met with only limited success in enforcing them. For example, in a case filed against the Xian International Trust and Investment Corporation as guarantor of a US\$35 million loan, the Supreme Court of Hong Kong found for the Western creditor, but the petitioner-creditor has yet to receive payment.²²⁰ In early 1991, Standard Chartered Bank received HK\$440 thousand after obtaining a judgment in Hong Kong against a Huaxian development corporation for HK\$5.24 million.²²¹

Hong Kong courts have occasionally succeeded in pressuring Chinese defendants and advancing the negotiation of loan refinancing agreements.²²² Generally, however, the unenforceability of Hong Kong judgments in China combined with the highly complicated and time-consuming service of process to parties on the mainland through diplomatic channels makes this path unattractive to foreign bank branches.²²³

217. Leung, *supra* note 204, at 3.

218. Chang, *supra* note 201, at 2.

219. See US Bank, China Settle Long Delayed Loan Dispute, Reuters, BC Cycle, June 5, 1991, available in LEXIS, World Library, Allwld File.

220. See Den Norske Syndicate Obtains Judgment Against XITIC, China Banking & Fin., Apr. 14, 1991, at 6; Chang, *supra* note 201, at 2.

221. See Hongkong and Chartered Banks in New Legal Action, China Banking & Fin., Mar. 4, 1991, at 10. For information about additional Chinese loan default cases brought in Hong Kong court see First Chicago Judgment Offers Comfort to Banks, China Banking & Fin., Mar. 12, 1990, at 2; Hongkong Bank Seeks Recovery on Hainan Facility, China Banking & Fin., Mar. 12, 1990 at 4; Chang, *supra* note 201, at 2, 5.

222. See Loan Enforcement A Trial of Patience, China Banking & Fin., Aug. 26, 1991, at 6. After a syndicate of banks led by Den Norske Bank took out writs in both Hong Kong and London, the defendant, Beijing Hua Wei Center Company Ltd., signed a loan financing agreement. *Id.*

223. See Christopher Smith, Bringing PRC Borrowers to Court, China Banking & Fin., Aug. 27, 1990, at 2.

c. *Redress in Chinese Courts*

The lenders in the Guangdong Loan Enforcement Case were frustrated in their attempts to enforce the judgment of the Hong Kong court and therefore brought an action against the land-owning agency in China.²²⁴ Petitioning the Peoples' Courts is viewed as a last resort for foreign bankers because the legal system is unpredictable and the plaintiff must deposit .5% of the sum claimed before the case can be heard.²²⁵ In addition, Chinese courts hearing loan default cases may absolve the guarantor of any liability if the defendants successfully argue that the lenders have been negligent in supervising the loan.²²⁶ In January 1992, a court in Guangzhou, however, impliedly recognized the inequity of this argument when it observed that a bank has a right to investigate and supervise a loan, but no obligation to ensure that it can be repaid.²²⁷ This was an intermediate court decision and is not binding in any other province.

As the Guangdong case suggests, a few foreign bankers have met with moderate success litigating in mainland China.²²⁸ Foreign creditors have also successfully petitioned to force a Chinese company into bankruptcy. In the summer of 1991, a Hong Kong bank joined domestic creditors and convinced a People's Court to declare a loan guarantor bankrupt.²²⁹ The protection of foreign bank lenders in China was further enhanced by a 1991 Supreme People's Court opinion. The Supreme People's Court, in *Handling of Loan Cases by People's Courts Opinion*, clarifies the rights and obligations of lenders and borrowers and includes detailed provisions for the handling of loan disputes.²³⁰ The opinion primarily describes the criteria for a case to be accepted by

224. See Leung, *supra* note 204, at 3.

225. Geoffrey Crothall, *Guarantor Forced into Bankruptcy*, S. China Morning Post, Aug. 6, 1991, at 1.

226. *Id.*

227. See *Court Decides Obligation to Supervise Loan*, China Banking & Fin., Jan. 30, 1992, at 12.

228. See Leung, *supra* note 204, at 3. According to one source, Guangdong officials were harassed by Chinese judicial officials until they agreed to pay. *Id.*

229. Crothall, *supra* note 225, at 1; *Loan Enforcement A Trial of Practice*, *supra* note 222, at 6. Anthony Russell, head of the China division of the Hong Kong & Shanghai Banking Corporation, explained that "[t]his demonstrates that [foreign bankers] are not prepared to sit idly by in the case of other nonperforming guarantors." Crothall, *supra* note 225, at 1.

230. Supreme People's Court Opinion on Loan Cases, China Banking & Fin., Apr. 9, 1992, at 5.

the People's Courts, for loan relationships to be declared void, and for guarantors to be found liable.²³¹

2. Limitations Engendered by Regulation

a. *Scarcity of Reliable Information*

Even though foreign banks must submit financial reports on a monthly basis and have audits performed by accountants registered in China, the government does not require Chinese companies to conduct audits or prepare complete financial statements.²³² In addition, annual reports often contain little more than a picture of the chairperson and glowing accounts of financial successes.²³³ Therefore, foreign bankers, who find it difficult if not impossible to conduct their own investigations, must rely on the insufficient and incomplete information provided by the Chinese companies.²³⁴

b. *Limited Lending Opportunities*

Because foreign banks and branches face limited lending opportunities, a decline in one sector of the economy can have a devastating effect. During the 1980s, foreign banks primarily financed hotel construction projects.²³⁵ The decline in tourism after Tiananmen led to an immediate oversupply of hotel rooms and the inability of many hotels to make loan payments.²³⁶ Although banks and branches have diversified into financing industrial and infrastructure projects and

231. *Id.* All disputes between citizens, between citizens and organizations, and between citizens and legal persons involving foreign exchange, state treasury securities, or other securities will be accepted by the people's court. *Id.* at 5 (Opinion, items 1, 2). For a case to be accepted, the plaintiff must have a direct interest in the outcome; there must be a specific defendant, a specific claim, and factual grounds; the plaintiff must provide documentary evidence; and the court must have jurisdiction. *Id.* at 6. A loan is void if one party uses fraud, coercion, or takes advantage of a superior position. *Id.* A guarantor, having expressed the intent to serve as such, bears joint and several responsibility when the borrower cannot repay the loan. *Id.*

232. See Gerard, *supra* note 15.

233. *Id.*

234. See Shale, *supra* note 102; Moy, *supra* note 16, at 2.

235. See Ipson, *supra* note 17, at 2; David Faulkner, New Visitor Arrivals Help Restore Demand, *S. China Morning Post*, May 29, 1993 (Supp.), at 8.

236. See *id.*

securities investments, the potential remains for many loan defaults to follow a slump in one economic area.

B. Regulatory Response

This section outlines regulation adopted to respond to the problems in the areas of foreign exchange, guarantees, and secured transactions.

1. General Foreign Exchange Regulation

The SAEC joins forces with the PBOC in regulating and establishing the rates for foreign exchange transactions in both Shanghai and the SEZs.²³⁷ To maintain its grip on foreign exchange and to control the size of China's foreign debt, the SAEC issued the Foreign Debt Statistical Monitoring Tentative Provisions in August 1987 ("Tentative Foreign Debt Provisions").²³⁸ These require foreign financial institutions to register all foreign exchange loans periodically.²³⁹ In addition, within fifteen days of signing a loan contract, a bank's client must present a copy of the contract and complete the necessary registration procedures to obtain the requisite Individual Debt Registration Certificate from the local branch of the SAEC.²⁴⁰

In February 1989, the State Council published a circular that tightened the SAEC's control over foreign debt incurred by domestic enterprises.²⁴¹ Several months later, the SAEC adopted registration procedures to accompany this circular. The Administration of Foreign Exchange Loans Registration Procedures ("Loan Administration

237. 1985 SEZ Foreign Banking Regulations, *supra* note 78, arts. 4, 11; 1990 Shanghai Foreign Banking Procedures, *supra* note 83, art. 14.

238. Graham Morrison, Debt Registration in the People's Republic of China, *China Banking & Fin.*, Dec. 18, 1989, at 2.

239. *Id.* at 2. Non-financial institutions must register on a loan-by-loan basis. *Id.*

240. See Dong Shizhong, Danian Zhang, and Milton Larson, Trade and Investment Opportunities in China: The Current Commercial and Legal Framework 97 (1992). Fines for violations can be as high as 3% of the external debt involved. *Id.* See also Christopher G. Oechsli & Chen Show-Mao, New Regulations on Foreign Loans: Preparing for Less or for More Borrowing?, *E. Asian Executive Rep.*, Oct. 1987, at 9.

Foreign banks and other entities must also register the transfer of foreign exchange loans under the SAEC Measures of Administration and Registration for Transferred Foreign Exchange Loans, published in November 1989. See Dong, Zhang, & Larson, at 98.

241. See Morrison, *supra* note 238, at 2.

Procedures") implement a system for registration of all foreign exchange loans under the control of the SAEC and its branches.²⁴² As with the original Tentative Foreign Debt Provisions, it is the responsibility of the borrower and not the lender to register foreign currency debt.²⁴³ Foreign bank branches and other financial institutions, however, are required to provide copies of receipt and payment vouchers to the local exchange control department.²⁴⁴

Local branches of the SAEC have also passed regulations to implement the February 1989 circular. The Guangdong SAEC, for example, issued rules that differ from the national procedures in three important areas that affect foreign bank branches.²⁴⁵ First, the procedures establish a minimum loan period of three months.²⁴⁶ Second, with SAEC approval, borrowers may remit loan repayments outside of the PRC.²⁴⁷ Third, a foreign bank branch or other financial institution is required to "supervise and urge" a borrower to comply with the registration procedures.²⁴⁸ The rules, however, do not offer an explanation of the terms "supervise" or "urge."

The February 1989 circular and the local SAEC regulations were clarified and codified in the Administration of International Commercial Loans by Domestic Organization Procedures, promulgated by the SAEC in 1991 ("Administration of International Loans Procedures").²⁴⁹ These procedures require a foreign bank branch to work closely with the SAEC and PBOC-sanctioned branches in examining, approving, supervising, and administering foreign exchange loans to domestic

242. Administration of Foreign Exchange Loans Registration Procedures [hereinafter *Loan Administration Procedures*], translated in *China Banking & Fin.*, Dec. 18, 1989, at 4.

243. *Id.* arts. 4-8.

244. *Id.* art. 10.

245. The Guangdong Province, Administration of Foreign Exchange Loans Registration Implementing Rules [hereinafter *Guangdong Loan Administration Rules*], translated in *China Banking & Fin.*, Jan. 29, 1990, at 9.

246. *Id.* art. 4.

247. *Id.* art. 8.

248. *Id.* art. 11.

249. Administration of Borrowing of International Commercial Loans by Domestic Organizations Procedures [hereinafter *Administration of International Loans Procedures*], translated in *China Banking & Fin.*, Nov. 4, 1991, at 7. See also Editor's notes, *China Banking & Fin.*, Nov. 4, 1991, at 10. International commercial loans, termed "foreign exchange loans" in this note, include commercial loans in foreign exchange made to domestic enterprises by foreign financial institutions, including trade contracts, buyers' credits, and lease-financing agreements. *Id.*

enterprises.²⁵⁰ If a bank enters a loan agreement without proper authorization, the contract can be voided by the SAEC.²⁵¹ Therefore, while the domestic enterprise is charged with registering the loan and there are no penalties imposed on a lender that fails to supervise, the foreign bank will be the big loser if a borrower is remiss in its responsibilities.

The SAEC's approval criteria for foreign exchange loans to domestic borrowers vary according the length of their terms. Each foreign bank branch receives a SAEC quota determining the amount of foreign exchange the branch may use for short-term loans (those less than one year).²⁵² Short-term loans may only be given to export businesses for working capital.²⁵³ Medium and long-term loans (those with terms between one and ten years) must be used to import high technology or to fund projects that will generate foreign exchange.²⁵⁴ The procedures do not require foreign bank branches to investigate the disposition of proceeds from their foreign currency loans.

The procedures may, however, extend liability to a foreign branch that loans foreign exchange to an unauthorized domestic borrower. The Administration of International Loans Procedures detail the two types of domestic organizations that may borrow international commercial loans:

- (i) financial organizations authorized by the SAEC to handle foreign loans; and
- (ii) authorized industrial and trading enterprises and enterprise groups.²⁵⁵

If a bank enters a loan agreement with an unauthorized entity, the People's Court may invalidate the contract.²⁵⁶

250. Administration of International Loan Procedures, *supra* note 249, art. 3.

251. See, e.g., *Unauthorized Guarantee Declared Invalid*, *China Banking & Fin.*, Jan. 29, 1990, at 4 (citing a case where the SAEC declared void the unauthorized foreign exchange guarantees given by a Beijing-based trade company to a foreign company and actually prohibited the guarantor from making payment).

252. Administration of International Loans Procedures, *supra* note 249, art. 13.

253. *Id.* art. 17. "Working capital" is defined as the current assets of an organization, specifically cash, accounts receivable, inventory, and equipment. *Barron's Dictionary of Banking Terms* 679 (Thomas P. Fitch ed., 2nd ed. 1993). "Registered Capital" is the aggregate amount of capital subscribed to by owners and investors. *Id.*

254. *Id.* arts. 5, 6.

255. *Id.* art. 2.

256. See *Unauthorized Guarantee Declared Invalid*, *supra* note 251, at 4.

In general, foreign bankers have found that the SAEC is cooperative but lacks experience in the creation of comprehensive and straightforward regulations.²⁵⁷ Domestic borrowers, moreover, are not always responsive to SAEC rules, leaving foreign banks responsible for authorization and registration of the loans. Fortunately, the procedures for foreign branches to extend loans are usually *pro forma* and approval is not difficult to obtain.²⁵⁸

2. Guarantees

Until the mid-1980s, foreign bankers had no way of securing loans to Chinese enterprises. Banks were therefore forced to rely on the Bank of China and other Chinese government institutions to provide guarantees.²⁵⁹ Guarantees are agreements signed by third parties who promise to fulfill the obligation of the debtor should that person or enterprise fail to perform.²⁶⁰ The guarantees issued by Chinese enterprises in the 1980s, however, often proved to be unenforceable and were not ultimately endorsed by the Chinese government, contrary to the convictions of many foreign investors.²⁶¹

In September 1991, the SAEC issued regulations to address the problems foreign bankers encountered enforcing guarantees after the Tiananmen Square incident.²⁶² As a result, only specified financial organizations can extend foreign exchange guarantees, and the SAEC is responsible for the approval, administration, and registration of all such guarantees.²⁶³ In addition, a Chinese law office must issue a legal opinion for all foreign exchange guarantees.²⁶⁴

Unfortunately, these regulations often hurt the foreign banks that they were designed to protect. Foreign bankers occasionally have difficulties determining whether or not they are dealing with authorized

257. Interview with David Warner, *supra* note 8.

258. *Id.*

259. See Dong, Zhang & Larson, *supra* note 240, at 74.

260. See Barron's Dictionary of Banking Terms, *supra* note 253, at 292.

261. See *supra* Section V(A)(1)(a).

262. See Administration of Domestic Organizations Providing Foreign Exchange Guarantees to Foreign Entities Procedures [hereinafter Administration of Forex Guarantees], translated in China Banking & Fin., Nov. 4, 1991, at 2. These procedures clarified the Strengthening the Administration of International Commercial Borrowing Circular of 1989. See Editor's Notes, China Banking & Fin., Nov. 4, 1991, at 4.

263. Administration of Forex Guarantees, *supra* note 262, arts. 3, 4.

264. Lending to China: Banking on the Long Term, *supra* note 203.

foreign exchange dealers and whether or not their transactions have received prior SAEC approval. If either the guarantor or the contract is unauthorized, the underlying loan agreements or guarantees may be declared invalid.²⁶⁵ In addition, bank officials have problems ascertaining whether a guarantor has complied with its prescribed financial limits.²⁶⁶

3. Secured Transactions

Because guarantees have often failed to adequately protect foreign banks, China has gradually developed a legal framework to collateralize loans. Before legislation on secured transactions was introduced in 1986, many foreign bankers engaged in project finance, a specific type of secured transaction where the project cash-flow and potential earnings serve as collateral. While Chinese regulations do provide for foreclosure in project finance, most U.S. banks usually opt to call the guarantee or renegotiate the terms of the loan agreement.²⁶⁷ In the case of FIEs, the bank may instead encourage the foreign partners to contribute more capital.²⁶⁸ From the bank's perspective, default is not so ominous in a project finance scenario because the lender can always collect something from the venture and because FIEs with government or quasi-government partners usually are provided with project completion guarantees.²⁶⁹ The low risk level and potential for high returns from future earnings prompted one representative of a U.S. bank to describe project finance as "very profitable" for foreign bank branches.²⁷⁰

Secured lending, which is much less common in China, became possible after the 1986 passage of the Regulations on Mortgage Loan Administration in the Shenzhen SEZ ("Shenzhen Mortgage Regulations").²⁷¹ Secured lending differs from project finance in that

265. See Unauthorized Guarantee Declared Invalid, *supra* note 251, at 4.

266. See Administration of Foreign Exchange Services Engaged in by Designated Foreign Exchange Banks, translated in *China Banking & Fin.*, Mar. 4, 1991, at 7.

267. Telephone Interview with David Warner, *supra* note 8.

268. *Id.*

269. See Dong, Zhang & Larson, *supra* note 240, at 77-78.

270. Citibank Bullish on Long Term Prospects in China, *China Banking & Fin.*, Nov. 5, 1990, at 2.

271. Regulations on Mortgage Loan Administration in the Shenzhen SEZ [hereinafter *Shenzhen Mortgage Regulations*], translated in *Intertrade* 72 (May 1986). See also Dong, Zhang & Larson, *supra* note 240, at 85. In China, unlike in the U.S., the terms "mortgage" and "secured loan" are synonymous. Because the state owns all land, "land-use rights," or leases,

the loan is collateralized by a security interest taken in actual personal or real property, not in the profits or proceeds from a venture.²⁷² After February 1986, foreign bank branches and other financial institutions located in the Shenzhen SEZ could engage in secured lending with FIEs established in the zone.²⁷³

The Shenzhen Mortgage Regulations stipulate that the loan agreement must be a written contract that has been registered with the proper authorities.²⁷⁴ The mortgagor must have the consent of the mortgagee to lease, sell, transfer, or further mortgage the property.²⁷⁵ If the mortgagor fails to repay before the end of the term, the foreign bank branch has recourse to dispose of the mortgaged property through auction sale or transfer.²⁷⁶

The principles underlying the local Shenzhen regulations were eventually incorporated into the General Principles of Civil Law adopted by the National People's Congress in January 1987.²⁷⁷ Article 89 provides that a debtor or third party may use its property as collateral for a mortgage.²⁷⁸ If the borrower fails to repay the debt or otherwise breaches the underlying contract, the lender is granted a priority right equal to the value of the loan and may credit it against the obligation or may sell the collateral and obtain compensation from the proceeds.²⁷⁹

serve as collateral in the same manner as other types of chattel, inventory, or equipment. See Economic History of China, Bus. Int'l: China Hand, Oct. 19, 1992, available in LEXIS, World Library, Allwld File; Zheng Caixiong, Real Estate Rules to Save Farmland, China Daily, Sept. 5, 1993 (Business Weekly Supp.), available in LEXIS, World Library, Allwld File; Madelyn C. Ross & Kenneth T. Rosen, China's Real Estate Revolution, China Bus. Rev., Nov.-Dec. 1992, at 44.

272. Barron's Dictionary of Banking Terms, *supra* note 253, at 547.

273. Shenzhen Mortgage Regulations, *supra* note 271, art. 2. The regulations specify that property, including buildings and materials, negotiable securities, and payment receipts, may be used as loan collateral. *Id.* arts. 5, 6. Originally, land was also excluded. See *infra* note 284. Note that mineral and natural resources also may not be used as collateral. Shenzhen Mortgage Regulations, *supra* note 271, arts. 5, 6.

274. Shenzhen Mortgage Regulations, *supra* note 271, arts. 11, 13, 14.

275. *Id.* art. 18.

276. *Id.* arts. 22-26.

277. General Principles of Civil Law of the PRC, The Laws of the People's Republic of China, 1983-1986, at 225 (Legislative Affairs Commission of the Standing Committee of the National People's Congress, ed., 1987). See also William C. Jones, Some Questions Regarding the Significance of the General Provisions of the Civil Law of the People's Republic of China, 28 Harv. Int'l L. J. 309 (Spr. 1987).

278. General Principles of Civil Law of the PRC, *supra* note 277, art. 89.

279. See Dong, Zhang & Larson, *supra* note 240, at 84.

While a national law on secured transactions has yet to be drafted by the National People's Congress, foreign banks today offer secured loans in accordance with local legislation. The protection of secured interests afforded by the regional regulations was recognized and enhanced by a Supreme People's Court opinion in July 1992.²⁸⁰ Further, the relevant sections of the opinion on China's Civil Procedure Law suggest that mortgagees and holders of secured debts will have priority for repayment if the mortgagor is declared insolvent.²⁸¹

After secured transactions were legitimized by the General Principles of Civil Law, an amendment to the Chinese Constitution in 1988 created an additional category of acceptable collateral.²⁸² The amendment authorized the transfer and acquisition for compensation of "land-use rights."²⁸³ Subsequent local secured loan regulations in Shanghai permitted banks to accept land-use rights, including leaseholds on buildings, their improvements, and land, as collateral for a mortgage loan.²⁸⁴

An increase in the number of transactions secured by land-use rights and other collateral prompted officials in Guangdong to promulgate secured loan provisions that applied to all three of its SEZs

280. New Legislation Governs Capital Contributions and Liquidation, *China Banking & Fin.*, Nov. 12, 1992, at 3, 5. The Supreme People's Court, *Several Questions on the Application of the PRC, Civil Procedure Law Opinion*, includes a section on the bankruptcy of FIEs and a commentary on the Civil Procedure Law. *Id.*

281. *Id.* According to the 1986 Law on Enterprise Bankruptcy, either the debtor or the creditors may file a bankruptcy or insolvency petition with the People's Court. Law of the PRC on Enterprise Bankruptcy, *The Laws of the People's Republic of China, 1983-1986*, at 289 (Legislative Affairs Commission of the Standing Committee of the National People's Congress, ed., 1987). According to the 1992 Supreme People's Court opinion, once the court rules to commence a procedure for debt repayment by an insolvent enterprise, it notifies the debtor, all known creditors, and issues a public notice. *New Legislation Governs Capital Contributions*, *supra* note 280, at 5. "Public notice" requires that the names of the debtors, the place and time limit for creditors to report claims, and the time and place of the first creditor's committee meeting be published in a newspaper. *Id.*

282. See Constitutional Amendment Approved, *Xinhua News Service*, Apr. 12, 1988, available in LEXIS, World Library, Txtfe File. "Land-use rights" are also translated "leaseholds." See also Dong, Zhang & Larson, *supra* note 240, at 86.

283. Constitutional Amendment Approved, *supra* note 282.

284. See Measures of the Shanghai Municipality Concerning the Transfer of Land Use Rights for Value [hereinafter *Shanghai Land-Use Rights Measures*], translated in *E. Asian Executive Rep.*, Mar. 1988, at 24.

and effectively repealed the Shenzhen Mortgage Regulations.²⁸⁵ The 1990 Guangdong provisions increase the types of parties that may participate in secured transactions to all enterprises and individuals in the SEZs and to banks outside of the SEZs.²⁸⁶ Any foreign bank or branch extending mortgage loans to entities in a Guangdong SEZ will therefore be covered by these regulations.²⁸⁷ Under the new provisions, state-owned enterprises may use property as security with proper authorization, allowing foreign bank branches to engage in secured transactions with state organizations.²⁸⁸ Further, a branch may not foreclose when a mortgagor leases, sells, transfers, or further mortgages the property.²⁸⁹

Other municipalities have issued their own regulations on secured transactions based on the Shenzhen and Guangdong legislation.²⁹⁰ Many of these local regulations, though, place different restrictions on mortgage and security procedures in their respective jurisdictions. In Guangzhou, for example, mortgagees face special legal difficulties foreclosing on recalcitrant borrowers.²⁹¹ The Tianjin regulations limit the mortgage levels to a certain percentage of the net value of the

285. Guangdong Province Special Economic Zones, Administration of Secured Loans Provisions [hereinafter *Guangdong Secured Loan Provisions*], translated in *China Banking & Fin.*, Apr. 9, 1990, at 5. The three SEZs in the Guangdong Province are Shenzhen, Zhuhai, and Shantou. See *supra* note 79 and accompanying text.

286. *Guangdong Secured Loan Provisions*, *supra* note 285, art. 3.

287. *Id.* Cf. *Shenzhen Mortgage Regulations*, *supra* note 271, art. 2.

288. *Guangdong Secured Loan Provisions*, *supra* note 285, art. 8. Approval must be obtained from the finance department or the state-owned capital administrative department of the county or SEZ. *Id.*

289. *Id.* art. 22. Cf. *Shenzhen Mortgage Regulations*, *supra* note 271, arts. 18, 20. When the borrower rents, sells, donates, or uses the collateral again as security without the lender's permission, the lender can recall the principal and interest in advance and require the borrower to pay penalties for breach of contract, but can not automatically foreclose. *Guangdong Secured Loan Provisions*, *supra* note 285, art. 33. The provisions actually specify the only four situations when a lender has the power to foreclose: at the end of the time period of the loan agreement; if the borrower fails to pay the principal and the interest pursuant to the agreement; if the borrower goes bankrupt in accordance with the law; or if the borrower dies intestate. *Id.* art. 23. The provisions spell out the procedures for foreclosure, giving the lender a choice between an auction or transfer. *Id.* arts. 24-28.

290. See Dongguan and Wuhan Issue Security Regulations, *China Banking & Fin.*, Dec. 17, 1992, at 1.

291. *Guangzhou Issues Real Property Mortgage Procedures*, *China Banking & Fin.*, Aug. 27, 1990, at 7. Note that any conflict between these procedures and the *Guangdong Secured Loan Provisions* will be decided in favor of the Guangdong provisions, promulgated on the provincial level. See *Guangdong Secured Loans Provisions*, *supra* note 285, art. 10.

property.²⁹² In Wuhan, provisions do not provide for third parties to offer security.²⁹³ For the most part, however, the various pieces of new legislation afford secured creditors protection comparable to that offered in the Shenzhen and Guangdong regulations.

Asian financial institutions seem to be more receptive to the idea of mortgage financing than are Western banks.²⁹⁴ The Bank of East Asia has aggressively arranged such financing to FIEs for the expansion of existing facilities and for the purchase of apartments for expatriate staff.²⁹⁵ The construction of the Guangdong World Trade Center in 1990 was financed in part by a Singaporean bank through a US\$30 million mortgage on the land-use rights and the building under construction.²⁹⁶

Most American and European bank branches, however, have been hesitant to engage in secured transactions, particularly mortgage financing.²⁹⁷ The Bank of America, for example, will only mortgage apartments for ex-patriots if their companies guarantee the loans.²⁹⁸ The rationale behind this reluctance is multi-fold. In contrast with U.S. regulations, China has no uniform law to regulate the creation of security interests, no means for perfection, and no mechanism for prioritizing liens (i.e., resolving conflicts between creditors with security interests in the same collateral).²⁹⁹ In addition, many cities have not enacted mortgage regulations, making conduct of this type of business impossible there. Finally, many foreign bankers fear payments from foreclosures will be made in *renminbi* without any foreign exchange assurances.³⁰⁰

While Hong Kong banks share these same concerns, they have remained bullish on lending to China, making use of the new secured

292. Tianjin Procedures Govern Mortgages, China Banking & Fin., Oct. 9, 1991, at 3.

293. Dongguan and Wuhan Issue Security Regulations, *supra* note 290, at 1.

294. Interview by Pam Baldinger of Anthony Russell, *supra* note 76.

295. More Bank Branches a Boon for Firms Operating in Shanghai, *supra* note 76, at 155.

296. Guangzhou Issues Real Property Mortgage Procedures, *supra* note 291, at 10.

297. See More Foreign Banks a Boon for Firms Operating in Shanghai, *supra* note 76, at 155. See also Graham Morrison, Restructuring China Loans, China Banking & Fin., May 20, 1991, at 2 (most foreign lenders have no security interest).

298. See More Bank Branches a Boon for Firms Operating in Shanghai, *supra* note 76, at 155.

299. See Dong, Zhang & Larson, *supra* note 240, at 79.

300. See *id.*

transaction regulations despite their obvious inadequacies.³⁰¹ The continued flood of capital from Hong Kong into China's southern provinces fueling the economic boom is the result of a variety of factors including: the colony's proximity to Guangdong; the desire for investment opportunities as the cost of labor and resources in Hong Kong soars; easier access to information about Chinese enterprises; prospering economic climate, and administrative regulations that are more readily available to Hong Kong investors; and the close social, cultural, and linguistic ties between Hong Kong and China.³⁰²

VI. CONCLUSION

The People's Republic of China of the 1990s offers a vast array of opportunities for foreign bankers. As Asian banks hasten to penetrate the financial market that boasts more than a billion people in the most dynamic economic region of the world, American banks must act quickly to get in on the ground floor.

Recognizing that the complex legal environment in China may present a murky maze to foreign bankers, this article provides an in-depth analysis of the various investment vehicles available to foreign bankers. Based on their objectives and requirements in the Chinese market, foreign banks may choose to open representative offices, branches, or joint venture banks. In deliberating over their options, bankers should consider the benefits and the risks inherent in China's still nascent legal regime. The lessons learned from the loan defaults of the late 1980s, in particular, should be applied to the present and future operations of foreign banks.

Although this article endeavors to assist foreign banks in assessing their level of involvement in China, foreign bankers must realize that the threshold question, whether or not to enter the Chinese market at all, has already been answered for them by the reality of explosive economic growth in what will soon be the world's largest market.

301. See Hong Kong Sponsorship Statement - The Stock Exchange of Hong Kong Ltd., Reuter Textline: Institutional Investor, Oct. 31, 1991, available in LEXIS, World Library, Txtnews File. Hong Kong banks and investors are responsible for 30% of China's foreign exchange earnings and 80% of syndicated loans. *Id.*

302. See H.D.S. Greenway, Greater China's Economic Powerhouse, *Boston Globe*, Apr. 1, 1993, at 19; Hong Kong: Taming the 'Wild West' Territory, *The Independent*, Apr. 6, 1993, at A28; Andrew Wang, China Real Estate Lures Investors, *Calgary Herald*, July 13, 1992, at B3; China-Hong Kong Emerge as Economic Powerhouse in Asia, *supra* note 147.

