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Henry R. Zheng

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Foreign Banking in the People's Republic of China: Laws and Practice

Foreign banking in the People's Republic of China (PRC or China) has expanded rapidly since the late 1970s when China's open-door policy started to take shape. By the end of 1985 over one hundred foreign financial institutions had set up 159 representative offices¹ and more than eleven foreign banks had opened branches in China.² The increase of foreign banking business in China is the natural outgrowth of the rapid expansion of China's foreign economic relations. The growth in foreign investment and trade in China has generated a great demand for international finance, increasing business opportunities for foreign banks and

*S.J.D., LL.M., University of Michigan Law School; LL.B., the Law Department, Peking University. The author currently serves as international legal consultant for Graham & James.

1. *Haiwai Jinrongzuzhi Fenfen Laihua Shedian, Changzhu Jigou Yida 159 Ge. (Overseas Financial Institutions Set up Establishments in China: Permanent Establishments Already Reached 159)*, Renmin Rebas (People's Daily), Feb. 4, 1986 [hereinafter People's Daily] (Unless otherwise indicated all the references in this article to *People's Daily* refers to the overseas edition published in Chinese). The 159 representative offices established by foreign financial institutions include those set up by 79 foreign banks and multiple offices of the same bank. *Id.* See also LeBourgeois & Chung, *Commercial Banks in China*, CHINA BUS. REV., Jan.-Feb. 1986, at 26. The authors of that article cited the information provided by the People's Bank of China and noted "as of Dec. 1985, there were some 170 Branches and representative offices of foreign financial institutions in PRC." *Id.*

2. These include the 11 branches set up in the Special Economic Zones (SEZ) after April, 1985, when the Chinese Government officially allowed foreign banks to branch in limited geographic areas, and 4 branches in Shanghai owned since 1949 by Hong Kong and Singapore banks. *Overseas Financial Institutions Set up Establishment in China*, *supra* note 1. See also *China Business Briefs*, Asian Wall St. J. Weekly, Feb. 11, 1985, at 12.

The need for funds in the Chinese market is also growing rapidly. China used \$2.43 billion in foreign loans in 1984, up 80.4 percent from 1983, and received \$1.87 billion from direct foreign investment or credits, a 31.7 percent increase. *Id.* at 19. Chinese foreign borrowings will probably increase substantially during the seventh five-year plan. The Bank of China estimates that the total borrowing in China for the next five years will be \$40 billion. See LeBourgeois & Chung, *supra* note 1.

financial institutions. Developments in Chinese foreign banking law have accompanied the increase of foreign banking activities in China. Since the early 1980s, the Chinese Government has enacted several regulations governing foreign banking business in China. These laws, plus the foreign banking practice of PRC as it has developed in the past several years, form the fundamentals of the foreign banking legal framework in PRC today. This article reviews Chinese foreign banking laws and practices. The first section introduces the Chinese banking system and provides general background information about Chinese banking practice. Sections II through V discuss the various forms of banking activity in China, particularly their legal and procedural requirements and tax consequences. The last section provides a summary and a brief discussion of the future of foreign banking activities in PRC.

I. Banking System of PRC: Laws and Practice

The economic reformation launched in 1979 in PRC has brought about a restructuring of China's financial and banking system.³ Since 1979, China's banking and financial framework has rapidly outgrown its old conception and evolved into a more dynamic institutional system. Additionally, the role of banks in the economy has changed dramatically as the decentralization of the state-planned economic mode incorporates more and more free enterprise principles into a socialist economy. The following section will introduce the current PRC banking system and highlight major aspects of the PRC's banking practice.

A. PRC BANKING SYSTEM

The Chinese banking system is under the direct leadership of the State Council, consisting of a central bank, several specialized banks and many other types of financial institutions. The State General Administration of Foreign Exchange Control has assumed a special role in the management and regulation of the nation's foreign exchange.⁴ Additionally, foreign

3. See Lao Zhang, *Zhongguo Jinrong Guanli Tizhi Gaige de Tedian He Qiushi (Features and Pattern of the China's Financial Management Restructuring)*, ECONOMIC REPORTER, HONG KONG, No. 1947, Nov. 25, 1985, at 27. For detailed description on Chinese economic readjustment, see Huan Xiang, *Zhongguo de Jingji Gaige (China's Economic Readjustment)*, ECONOMIC REPORTER, HONG KONG, May 20, 1985.

4. The State General Administration of Foreign Exchange Control was set up in 1980 in accordance with interim regulations by the State Council. Interim Regulations for Exchange Control of the People's Republic of China, *reprinted in* CHINA INTERNATIONAL ECONOMIC CONSULTANT, INC., CHINA INVESTMENT GUIDE 1984/85 [hereinafter CHINA INVESTMENT GUIDE 1984/85], at 489. This administration has branches in major cities and provinces and has authority in foreign exchange control. Specialized banks and foreign banks must obtain a license from it to engage in foreign exchange business. The State General Administration

banks and financial institutions are allowed to operate in some special banking fields within limited geographic areas.⁵ The table at the end of this article presents a graphic description of the Chinese banking system and interrelations of various financial institutions.⁶

The central bank, the People's Bank of China (PBOC), was set up on December 1, 1948.⁷ For many years, it played a role of both central bank and commercial bank.⁸ In September 1983, as a part of the national financial reform, the State Council decided to restructure the PBOC to function exclusively as a central national bank in charge of overall banking and financial policy of China and coordinating and supervising the banking activities of specialized banks and other financial institutions.⁹ On January 7, 1986 the State Council promulgated the Interim Bank Regulations of the People's Republic of China, which reaffirm the central role of the PBOC in China's financial system and further define the PBOC's functions and structure.¹⁰ According to the interim regulations, the PBOC is a central bank with very extensive quasi-legislative and administrative power. The PBOC is authorized to prepare the national banking and financial policy, draft banking and financial laws and enact rules regulating banking and financial professions.¹¹ It also possesses the power to issue currency, to control national foreign exchange and gold reserves, and to

of Foreign Exchange Control was initially a department of the Bank of China. The Administration was put in charge of the People's Bank of China in 1983 when the PBOC became the central bank. Xie Shusen, *Guanyu Gaige Waihui Tizhi de Yixie Shexiang (Some Thoughts Regarding Restructuring Foreign Exchange Regulations)*, CAIJING YANJIU (FINANCE AND ECONOMIC STUDIES), 1985, No. 6, at 6.

5. For a discussion of the regulations concerning foreign banking in PRC see sections 2 through 6 of this article.

6. The Chinese banking system has developed rapidly for the past several years. The table is based on the most current banking regulations enacted in early 1986. Earlier publications may contain charts or descriptions different from this table. See, e.g., Wilson, *How Banks Work in China*, THE BANKER, Jan. 1980, at 19; *Cover Story: Monetary System and Banking*, PAKISTAN & GULF ECONOMIST, Oct. 5-11, 1985, at 18; Thorn, *Banking Structures and Sources of Finance in the Far East*, THE BANKER RESEARCH UNIT, Nov. 1974, at 58.

7. ZHONGGUO QIYE GUANLI BAIKE QUANSHU (ENCYCLOPEDIA OF CHINA BUSINESS MANAGEMENT) 1011 (Business Management Publishing House, Chinese ed. 1984).

8. The PBOC had been the most important commercial bank in the domestic context. The PBOC had 20,000 branches in 1957, see Thorn, *supra* note 6, at 58, and approximately 37,000 branches by the end of the 1970s. Wilson, *supra* note 6, at 21. Even after the newly established Industrial and Commercial Bank took over a major part of its banking business, the stationary and seals of the PBOC were still used. *Wogu Wudayinhang de Zhineng Youhe Butong (The Functional Difference of the Five Big Banks in China)*, People's Daily, Aug. 17, 1985.

9. China Daily, Oct. 2, 1983, at 4. See also Lao Zhang, *supra* note 3. This reformation led to the establishment for the first time in PRC's history of a special central bank.

10. Interim Bank Regulations of the People's Republic of China (IBR), promulgated by the State Council, effective Jan. 7, 1986, reprinted in People's Daily, Jan 18, 1986.

11. *Id.* art. 5.

regulate financial markets, including stocks, bonds and other negotiable instruments.¹² The examination and approval of the establishment of specialized banks and other financial institutions, as well as the supervision and coordination of their activities, are also within the power of the PBOC.¹³ The decision making power of the PBOC is assigned to a council established within the PBOC.¹⁴ The PBOC may establish branches in various geographic regions to perform functions of the central bank within each of their respective jurisdictions.¹⁵ The PBOC does not provide banking service directly for businesses or individuals.¹⁶

Under the leadership of the PBOC, several specialized banks in charge of banking and financial business in specific areas have been established. Currently, there are five main national specialized banks in operation: the Industrial and Commercial Bank of China; the Agriculture Bank of China; the People's Construction Bank of China; the China Investment Bank; and the Bank of China. The Industrial and Commercial Bank of China was established in 1983 to take over the urban commercial banking business formerly undertaken by the PBOC.¹⁷ This bank handles short term industrial and commercial credits and savings as well as individual savings and loans in cities and townships.¹⁸ The Agriculture Bank of China deals with savings and loans in rural areas for individuals and cooperatives.¹⁹ It also manages and controls the agricultural appropriation of the State.²⁰ The People's Construction Bank of China is specially in charge of state

12. *Id.*

13. *Id.*

14. *Id.* art. 7.

15. *Id.* art. 8.

16. *Id.* art. 11.

17. See authorities listed *supra* notes 8 and 9.

18. The Structure of the Industrial Commercial Bank of China was based on the urban branch network of the former PBOC. In 1985 it had 3,000 branches nationwide and employed 300,000 personnel. In 1984 the bank made loans of almost 300 billion yuan (about \$1.1 billion), accounting for over 70 percent of the deposits absorbed and loans granted throughout China. Brotman, *Reforming the Domestic Banking System*, CHINA BUS. REV., Mar.-Apr. 1985, at 20.

19. The Agriculture Bank of China was initially established in July 1951 under the name of Agriculture Cooperative Bank. The Agriculture Bank of China was formally established in March 1955. In April 1957, the bank was abolished and merged with the PBOC. It was reestablished in 1963 under the jurisdiction of the State Council and ranked equal to the then existing PBOC. Although it was not officially abolished during the Cultural Revolution, it was not active. In 1979, the Agriculture Bank of China was activated again in order to carry out China's economic reform policy in the agriculture sector. In 1983, when the PBOC was restructured into a central bank, its banking business in rural areas was taken over by the Agriculture Bank of China. K. HISAO, MONEY AND MONETARY POLICY IN COMMUNIST CHINA 38-40 (1971); K. HISAO, MONEY AND BANKING IN THE CHINESE MAINLAND 11-12 (Chung-Hua Institution for Economic Research, Taipei 1984); Thorn, *supra* note 6, at 61.

20. CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 29.

investment and capital construction.²¹ It manages the expenditure budget for the state's capital construction and provides loans and other banking services for most of the real estate projects and investment in fixed assets.²² The China Investment Bank was established in 1981 with funding support from the World Bank.²³ Its primary business is raising funds from abroad for domestic project investments.²⁴ The bank also serves as an intermediate financial institution for the receipt of industrial loans from the World Bank and other international financial institutions.²⁵ The Bank of China is primarily engaged in foreign exchange business.²⁶ It is in charge

21. The People's Construction Bank of China was established in 1954. This had been under the Ministry of Finance in charge of state appropriations for investment. It functioned more as an office for the Ministry of Finance than as a bank. Its major task was to manage the state funds. In 1979, as part of the economic reform, the bank began to extend repayable, interest-bearing loans to capital construction projects: this substantially changed the role of the bank in the economy. Lao Zhang, *supra* note 3, at 27. K. HISAO, MONEY AND BANKING IN CHINESE MAINLAND, *supra* note 19. As of January 1985, interest bearing loans replaced fiscal appropriations in most sectors. Only government departments, schools, and non-productive units are eligible for the free budgetary funds. Interim Regulations of the State Planning Commission, the Ministry of Finance and People's Construction Bank of China Concerning Replacing All Capital Construction Appropriation with Bank Loans, Dec. 14, 1984, reprinted in ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO (hereinafter THE STATE COUNCIL BULLETIN), Feb. 10, 1986, at 71-77.

22. Deposits in the Construction Bank come mainly from state budgetary appropriations and enterprise funds reserved for capital construction and investment in fixed assets. The Construction Bank made most of its loans passively based on the state plan with funds supplied by the state budget. The bank was given more and more autonomy, however, in extending or withholding loans. In a joint circular issued by the PBOC and other Chinese banks in late 1985, the Construction Bank was required to assume a positive role in examining the loans for capital construction or fixed assets. The local branches were urged to examine the feasibility of the projects as well as the likelihood of loan repayment. They were asked to refuse to lend to projects which failed to fulfill either of the two criteria, even though the projects were already incorporated into the state plan. Lao Zhang, *Zhongguo Jinrong Jigou Caiqu Cushi Jiaqiang Jinrong Guanli Tigao Jingjixiaoyi* (Chinese Financial Institutions Adopting Measures to Strengthen Financial Management and Enhance the Economic Return), ECONOMIC REPORTER, HONG KONG, No. 48, Dec. 2, 1985, at 45.

23. Lao Zhang, *supra* note 3, at 27.

24. CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 30.

25. *Id.* The Investment Bank depends primarily on funding from the World Bank. Through the first half of 1985 the bank received two loans totalling \$245 million from the World Bank. A third loan of \$100 million will be arranged soon. The President of the bank, Mr. Zhou Hanrong, stated at the Board of Directors meeting the source of funds of the bank should be expanded. The State General Administration of Foreign Exchange Control already approved the bank's efforts to seek funds from international financial markets. *Zhongguo Touzi Yinhang Choujie Zhongchanggi Daikuan* (The Investment Bank of China Seeking Medium and Long Term Loans), People's Daily, Apr. 19, 1986, at 1.

26. The Bank of China was founded in 1908. Before 1949 the bank had twenty-one branches abroad. After PRC was founded, part of the assets were taken over and the branches of the Bank of China in Hong Kong, Singapore, and London joined PRC. In 1969 the bank's assets totalled only about \$1.8 billion, but expansion was stimulated by the post-Mao open door policy in the late 1970s. On June 7, 1979, the bank opened in Luxembourg its first new overseas branch in thirty years. Stepanek, *A Ten-Year Profile of the Bank of*

of the settlement of most of China's international transactions. It handles foreign exchange deposits, loans and remittances for individuals and for businesses and international institutions.²⁷ The bank carries on extensive trust, investment, leasing and consulting activities.²⁸ It may also represent the state in the issuance of foreign exchange bonds and other securities.²⁹

The number of specialized banks will likely further increase in the near future. One of the major policy goals in the current financial reform in PRC is, as the Vice-President of the PBOC explained, "to reform the situation where a small number of banks monopolize the banking business, develop and establish a group of financial institutions, and gradually diversify the banking business. . . ."³⁰ These objectives can be achieved by a further increase in specialized banks. The Chinese Government decided recently to reestablish the Bank of Communications, a major commercial bank existing until the early 1950s in mainland China.³¹ The Bank of Communications will be a stock company financed through issuing shares.³² The business of the Bank will include both domestic and foreign currency.

Specialized banks are under the direct leadership of the PBOC. The establishment of a specialized bank requires approval from the PBOC and the State Council.³³ The bank must further obtain a business license from

China, CHINA BUS. REV., Sept.-Oct. 1979, at 55. By 1984, the bank had 261 branches in Singapore, Britain, Luxembourg and the United States, and representative offices in Tokyo and Paris. The bank also conducted representative business in 3,151 banks in 149 countries and regions. CHINA INVESTMENT GUIDE 1984/85, *supra* note 20, at 29. Its assets also increased to around \$70 billion. Zhang Bingde, *Zhongguo Yinheng Zaiduiwai Kaifang Zhengce Zhong De Zuoyong (The Role of Bank of China in Implementing Open-Door Policy)*, ECONOMIC REPORTER, HONG KONG, May 20, 1986, at 28; *Zhongguo Yinhang Shili Rezeng Zichane 2,600 Yi (The Assets of Bank of China Increased to 260,000 Million Yuan)*, People's Daily, Dec. 3, 1985.

27. The Bank of China traditionally monopolized China's foreign exchange business and international settlement. The 1980 State Council's interim regulations expressly designated the Bank of China as the specialized foreign exchange bank. See Interim Regulations for Exchange Control of the People's Republic of China, *supra* note 4, art. 3. Since 1979 a variety of international trust and investment companies have been established in China and have taken away a lion's share of foreign exchange business from the Bank of China. Some other Chinese commercial banks may also take foreign currency deposits from Chinese citizens. See People's Daily, Feb. 22, 1986, at 3.

28. According to a Chinese official report, by the end of 1985 the Bank of China had invested a total of \$270 million directly in 143 Sino-foreign joint ventures. China News Agency, News Release, Feb. 27, 1986.

29. The first overseas bond issuance by the Bank of China was in late 1984. By the end of 1985, the Bank of China had issued bonds in Japan and West Germany for a total of 70 billion Japanese yen, 150 million United States dollars and 150 million German marks. Morrison, *Borrowing on World Bond Markets*, CHINA BUS. REV., Jan.-Feb. 1986, at 20.

30. People's Daily, Nov. 14, 1986, at 1.

31. *Id.* The Bank of Communications dates back to imperial times, and was one of the four leading banks before PRC was established. See Thorn, *supra* note 6, at 61.

32. People's Daily, *supra* note 30, at 1.

33. See IBR, *supra* note 10, arts. 5, 19.

the PBOC and register with State Administration of Industry and Commerce before starting business.³⁴ Specialized banks may establish branches in various geographic regions. Such branching requires approval by the corresponding branches of the PBOC and registration by an appropriate authority.³⁵

In addition to specialized banks, a variety of other nonbank financial institutions also handles banking and financial business. These institutions are mostly investment and trust companies, finance companies and rural or city credit cooperatives. The investment and trust companies have mushroomed since 1979.³⁶ By late 1985, approximately twenty-seven investment and trust companies had been established at the state and provincial levels.³⁷ Many smaller and local investment and trust companies or finance companies also exist. Guangdong Province alone, by mid-1986, had over 300 investment and finance companies in active operation.³⁸ These investment and trust companies often conduct extensive banking and financial business. They operate trust deposits or trust investments, issue stocks, bonds or other securities in domestic and international financial markets, organize joint ventures, or make direct investments. They also engage in leasing, consultation, and other financial services.³⁹

The establishment of a national investment and trust company involves the filing of an application which is reviewed by the PBOC and approved by the State Council.⁴⁰ The establishment of other regional investment and trust companies is reviewed by the PBOC branch of the corresponding level and approved by the higher level of the PBOC.⁴¹ The regional government is prohibited from setting up local banks,⁴² but may set up in-

34. *Id.* art. 20.

35. To establish a branch at the provincial level, a specialized bank must apply and obtain approval from the head office of the PBOC. To set up a branch at city or regional level, the branch office of the specialized bank at the provincial level must apply and obtain approval from the provincial branch of the PBOC. *Id.*

36. The first investment and trust company in China was the International Trust and Investment Corporation (CITIC), established October 4, 1979. CHINA INVESTMENT GUIDE, 1984/85, *supra* note 4, at 249.

37. *Id.*

38. *Guangdong Jinrong Ye Chansheng Xinhuali (Finance Business in Guangdong Province Generating New Dynamics)*, Xinhua News Agency, Press Release, June 30, 1986.

39. For instance, the CITIC issued bonds in Hong Kong, Japan, and West Germany. It also helped organize over forty foreign-Chinese joint ventures. It established China Leasing Company, Ltd., and it also set up China Oriental Leasing Company, a Sino-Japanese joint venture. CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 29. Other investment and trust companies also conduct extensive foreign economic and finance business. Seventeen of the twenty-six financial institutions that the Chinese Government permits to guarantee foreign borrowings are investment and trust companies. ECONOMIC REPORTER, HONG KONG, Oct. 14, 1985, at 38.

40. See IBR, *supra* note 10, art. 25.

41. *Id.*

42. *Id.* art 28.

vestment and trust companies.⁴³ Specialized banks may also establish investment and trust companies or may engage directly in similar businesses.⁴⁴

The credit cooperative plays a role very similar to that of the credit union in the United States. It provides loans, accepts deposits, and settles accounts for individuals, small cooperatives or private businesses.⁴⁵ For many years credit cooperatives were located mainly in the countryside. By the early 1980s, 60,000 credit cooperatives existed in the countryside.⁴⁶ During the last several years, credit cooperatives also have begun to develop in cities. For instance, in Guangdong Province over 120 urban credit cooperatives had been established by mid-1986.⁴⁷ Other cities also have begun to experience similar developments.⁴⁸

B. CHINESE BANKING PRACTICE: AN INTRODUCTION

Chinese Banks traditionally have assumed a very strong administrative role in the national economy. For many years, all capital construction and investment in fixed assets were financed through fiscal appropriations.⁴⁹ A lion's share of working capital for enterprises also came from the state budget.⁵⁰ Bank loans, tightly controlled by the state credit plan, were available only for part of the working capital in industry and short term need in agriculture.⁵¹ The interest for deposits and loans was determined by the state and sometimes remained the same for many years.⁵² Thus, banks served very much as offices of the government in charge of the management of budgetary appropriations.⁵³

The trend in domestic banking is to restructure Chinese banks into business entities through decreasing governmental administrative control

43. *Id.* art. 25.

44. *Id.* art. 26.

45. *Id.* art. 27.

46. Wilson, *supra* note 6, at 21.

47. See Press Release, *supra* note 38.

48. In Shenyang, a large city in northeast China, seventeen urban credit cooperatives had been established by the end of 1985. These urban credit cooperatives held accounts with over 6,200 small enterprises, and deposits totalling over 150 million Chinese yuan. *Shenyang Jinrong Shichang Shifen Huoyu (Financial Market in Shenyang Getting Active)*, People's Daily, Feb. 8, 1986, at 3.

49. K. HISAO, *supra* note 19; see also Thorn, *supra* note 6, at 58-62.

50. K. HISAO, *supra* note 19; Thorn, *supra* note 6, at 58-62.

51. K. HISAO, *supra* note 19; Thorn, *supra* note 6, at 58-62.

52. For instance, the interest rate remained unchanged from 1972 to 1979. Before 1972, the interest rate also changed infrequently. Wilson, *supra* note 6, at 21.

53. This view is shared by some Chinese economists. In a seminar on China's financial reformation, a Chinese scholar contended that Chinese banks had functioned as a department of the government, rather than as a business. This was deemed the major obstacle to the efficiency of the banking business. *Jiakuai Jinrong Gaige de Bufa (Quickening Steps of the Financial Reformation)*, JINGJI YANJIU (ECONOMY STUDY), BEIJING, No. 12, 1984, at 77.

and to enhance the economic independence of banks. These developments are reflected in three major steps taken by the PRC Government. First, beginning in 1985 all budgetary appropriation for capital construction was converted to interest-bearing and repayable loans channeled through the Construction Bank.⁵⁴ This policy, plus some other reforms on the financing of working capital, has resulted in virtually all funding taking the form of bank loans. Second, banks are accorded growing autonomy in managing banking business. Banks now have limited power to extend or withhold loans based primarily on economic considerations, independent of administrative interference.⁵⁵ Third, Chinese commercial banks are allowed to maintain a floating interest rate, within the limit set by the PBOC, to compete with one another for business and to stimulate economic growth.⁵⁶ Banks will not ordinarily provide low-interest loans to enterprises unless local governments are willing to pay for the loss of interest.⁵⁷ Interbank funds transfer now takes the form of interest-bearing interbank loans. In principle, the interest rate is determined through agreements between banks, rather than by the government.⁵⁸

Further, the Chinese Government also adopted a series of measures to enhance competition among commercial banks. The Chinese Government broke up a monopoly of the Bank of China over foreign exchange transactions and other domestic commercial banks over domestic currency transactions. The current policy allows the Bank of China to take Chinese currency deposit and other commercial banks and investment and trust companies to engage in foreign exchange business.⁵⁹ Also, Chinese commercial banks began to issue debentures to compete with treasury bonds and meet the demand for funds.⁶⁰ By mid-1986, several major cities had

54. See Interim Regulations of the State Planning Commission, Ministry of Finance and the People's Construction Bank of China, *supra* note 21.

55. Article 49 of the IBR reads: "Specialized banks shall have autonomy in extending loans. No entity or individual may mandate the banks to grant loans or prevent them from recovering the lendings. Without the approval of the State Council, no entity may be relieved from the obligations to repay the loans." IBR, *supra* note 10, art. 49.

56. Article 42 of the IBR provides that the PBOC may establish the highest interest rate and the lowest interest rate and that specialized banks have the right to keep a floating interest rate within the limits determined by the PBOC. IBR, *supra* note 10, art. 42. Additionally, banks have power to impose penalty surcharges ranging from 20 percent to 50 percent of the original interest rate on overdue loans, unauthorized expenditures, or cost overruns. Brotman, *supra* note 18, at 19.

57. IBR, *supra* note 10, art. 43.

58. *Id.* art. 45.

59. The investment and trust companies have been allowed to engage in international finance and foreign exchange business since 1979, when the CITIC was established. In 1986, the PBOC began to allow the Bank of China to take Chinese currency deposit and the Agriculture Bank and the Industry and Commercial Bank to take foreign currency deposits in the areas approved by the PBOC. See People's Daily, Feb. 22, 1986, at 3.

60. The Industrial and Commercial Bank began to issue bonds in 1985. It issued bonds

established short-term financial markets and Chinese banks were actively engaged in various commercial paper discounts.⁶¹ In some major cities and abroad, Chinese banks and financial institutions also participate extensively in a variety of investment projects.⁶²

The change of the role of the Chinese bank in the national economy has its root in the ongoing economic reformation. The liberal economic policy instituted since 1979 has greatly diminished direct state control over the economy. Mandatory state plans have yielded, in many areas, to the indicative guideline, leaving producers increased flexibility and discretion regulated largely by the law of supply and demand. The liberalized economy made it possible for banks to function as businesses and to utilize economic leverage, such as credit, to direct the economy towards efficiency. In addition, the rapid economic growth and the proliferation of enterprises stimulated by the new economic policy generated a great demand for funds and a dynamic banking system. Banks serving merely as cashier offices for national budget appropriations with rigid administrative control became an obstacle to a dynamic economy.⁶³ The government became increasingly aware of the necessity to restructure the old banking system into a business.⁶⁴ The pattern of Chinese banking policy is to incorporate the banking system into the mainstream of the current economic reform and "turn the banks," as Chinese leader Deng Xiaoping proposed, "into real banks."⁶⁵

II. Foreign Banking in PRC: Options and Opportunities

Development of foreign banking business in the PRC results partly from growing foreign investment and trade interest in China. Some foreign

totalling 310 million yuan (about \$1.1 million) in 1985. People's Daily, Feb. 8, 1986. Agriculture Bank was planning to issue bonds of 1,500 million yuan in 1985 (about \$310 million) with the interest rate of 9 percent. The funds from issuing bonds would be used for special loans with interest rates ranging from 12 percent to 14 percent. Economy Daily, Beijing, Aug. 23, 1985.

61. *Wuda Zhongxin Chengshi Xingcheng Zijin Shichang (Five Major Cities Establishing Financial Markets)*, People's Daily, July 29, 1986, at 1.

62. By the end of 1985, the Bank of China alone had invested in over 140 joint ventures and total investment had reached \$270 million. People's Daily, Feb. 28, 1986. The CITIC also has extensive foreign investment. According to CITIC's President, CITIC has invested \$50 million per year outside China. Engle, *CITIC: Pacesetter Corporation*, CHINA BUS. REV., July-Aug., 1985, at 9.

63. For discussion on the need for financial reformation, see Cai Chongzhi, *Woguo Jinrong Tizhi Gaige De Tantaotao (Tentative Discussion on China's Financial Reformation)*, ECONOMY STUDY, BEIJING, No. 10, 1984, at 21-39; Zhou Shengye, *Jinrong Tizhi Gaige de Renwu he Zhongxin Huanjie (The Tasks and Central Issues of the Financial Reformation)*, ECONOMY STUDY, No. 7, 1985, at 53-57.

64. Lao Zhang, *supra* note 3, at 27.

65. *Id.*

banks followed their established foreign clients, who began to invest and develop business in China. Others look directly to Chinese enterprises and projects for potential financial opportunities. Although quite a few foreign commercial banks make loans directly to China from abroad, most of foreign bankers place emphasis on the importance of maintaining presence in China. This presence enables the foreign bank to closely monitor the market, observe business risk, obtain credit information, and develop business opportunities. Additionally, the Chinese laws concerning banking, monetary policy, and foreign exchange control develop rapidly. With less developed communication and information systems in China, maintaining constant presence is necessary for foreign banks to remain informed of the most recent policy and legal developments. As more foreign banks enter the Chinese market for business opportunities, competition is enhanced. Though direct lendings from abroad are still possible, foreign banks without presence in China find it increasingly difficult to compete with their counterparts, who maintain continued presence in China, in penetrating Chinese markets. Thus, maintaining presence in China becomes significant for foreign banks to preserve the competitive edge and achieve successful banking business.

The Chinese Government has increasingly recognized the importance of foreign finance to the furtherance of industrial modernization and the current liberal economic policy. The government's approach towards foreign banking practice, however, has been very cautious. Under present Chinese law, foreign banks may establish representative offices in major Chinese cities to perform liaison functions for head offices.⁶⁶ In the four special economic zones (SEZ), and in a few exceptional cases, in Shanghai, foreign banks may engage directly in banking business involving limited deposit taking and other financial activities.⁶⁷ In the latter situation, a foreign bank may either form a joint venture bank with Chinese financial institutions, set up a branch office, directly establish an independent subsidiary bank, or form a new bank with foreign capital.

So far foreign banks have made most extensive use of representative offices (RO) to conduct business in China. By early 1986 over 150 ROs had been established in China by various foreign financial institutions.⁶⁸

66. Administrative Procedures of the PBOC for the Establishment of Representative Office in China by Foreign or Overseas Chinese Financial Institutions (APER0) promulgated by the PBOC, effective Feb. 1, 1983, *reprinted in CHINA INVESTMENT GUIDE 1984/85, supra* note 4, at 547-49.

67. Regulations Governing Foreign Banks and Chinese-Foreign Joint Venture Banks in the Special Economic Zones of the People's Republic of China (RGFB), promulgated by the State Council on Apr. 2, 1985, *reprinted in THE STATE COUNCIL BULLETINS*, No. 464, May 10, 1985, at 349. For discussion of the foreign bank branches in Shanghai, see *infra* note 75 and accompanying text.

68. See *supra* note 1. Among the ROs that foreign financial institutions established in

An RO usually provides for the foreign clients of the head office introductions to and contacts with Chinese local authorities and enterprises. The RO also provides for its head office and clients credit analysis services and economic information on Chinese local business. Additionally, the RO introduces products, promotes the service of its head office and related nonbanking subsidiaries to the Chinese businesses and government agencies, and explores business opportunities for the head office and its customers. An RO is permitted to engage only in negotiation, liaison, consultation and other services for the head office.⁶⁹ The RO is not allowed to conduct any direct profit-making business.⁷⁰ In most instances ROs seem to serve as loan production offices, and loans initiated are ordinarily booked from head offices overseas. An RO apparently may take advantage of its Chinese presence to perform liaison services for foreign or Chinese businesses as well as its own head office and to receive commissions.⁷¹ An RO is also used by foreign banks as a starting point for Chinese venture. As the market developed gradually, quite a few ROs were later upgraded to full-fledged branches directly engaged in banking business.⁷²

China, thirteen were set up by eight American banks. Citibank had three ROs, in Beijing, Shanghai, and Shenzhen. The Bank of America had two ROs, one each in Shanghai and Beijing. *U.S. Bank Representative Offices in China*, CHINA BUS. REV., Jan.-Feb. 1986, at 27.

69. See APERO, *supra* note 66, art. 8.

70. *Id.*

71. Although Chinese law expressly prohibits foreign bank ROs from engaging in direct profit-making business, it does not define clearly what constitutes a "direct profit-making" business. According to a recent publication on foreign commercial banks in China, foreign bank ROs may engage in the following activities:

1. Gathering market information and establishing a network of government and corporate contracts.
 2. Providing information and facilitating trade financing (short of actually negotiating and issuing letters of credit), and helping customers avoid potential pitfalls and future trouble in their China business.
 3. Assisting customers in identification of potential joint venture partners, negotiation of joint venture agreements, and financing of joint venture projects.
 4. Acting on behalf of the head office and major domestic and overseas branches in interacting with the Bank of China and other Chinese financial institutions on correspondent banking business.
 5. Promoting products and services provided by the bank's related nonbanking subsidiaries.
- LeBourgeois & Chung, *supra* note 1, at 28.

Among the types of business described above, 2. and 3. are apparently fee-generating. Since a bank's business depends on loans and banking services for profits, arguably assisting a customer in negotiating a joint venture agreement and promoting products of the bank's related nonbanking subsidiaries are not directly related to profit-making from the bank's point of view. The fees received for such services offset office costs rather than contribute to bank profits. Some foreign banks openly advertise for providing investment consultation service. See CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 224-25.

72. In 1985, three foreign banks upgraded their ROs in Xiamen to branches. These are

Although the Sino-foreign joint venture started as early as the late 1970s, the Sino-foreign joint venture bank is a recent event in Chinese joint venture practice. The first joint venture bank, Xiamen International Bank, opened in Xiamen in November 1985 with 60 percent participation by a Hong Kong banking group and 40 percent by three Chinese financial institutions.⁷³ The joint venture bank is somewhat similar to the consortium bank in the international banking practice in that it constitutes an independent Chinese legal entity. Establishing a joint venture bank may provide foreign participants the opportunity to engage abroad in businesses they are prohibited by law from conducting at home. Joint venture banks also provide the advantage of the established client circle of the participating Chinese financial institutions. Furthermore, the direct Chinese financial commitment substantially reduces the business risk facing foreign investors.

One problem that could arise with a joint venture bank is the conflict of interest, particularly if the Chinese party has the same line of banking business in the same geographic area as the newly formed joint venture bank. This problem should be handled carefully in the joint venture contract in order to avoid subsequent disputes. The Xiamen International Bank's business has been mainly in the area of foreign related financial activities. Its three Chinese partners, the Industrial and Commercial Bank of China, Fujian Investment and Enterprise Corporation, and Construction and Development Corporation of Xiamen Special Economic Zone, are mainly in domestic or investment banking business. Thus, potential conflicts of interest among the partners have been kept to a minimum. The Xiamen International Bank so far has a successful story. This bank received fifteen loan applications with a total of \$100 million within its first three months of operation.⁷⁴ During the first six months of 1986, it declared a net profit of H.K. \$8.5 million.⁷⁵

Foreign banks were previously allowed to maintain branches in Shanghai engaging in limited direct banking business. This privilege, however, was limited to four foreign banks and based more or less on reciprocity as well as on their grandfather presence in that city before PRC was

China Bank Corp., Ltd., Hong Kong and Shanghai Banking Corp., and Bank of the Orient. *Xiamen Xingcheng Waixiangxing Jinrong Tixi (Xiamen Has Established Overseas-Oriented Financial Network)*, People's Daily, Feb. 27, 1986.

73. *Xiamen Guoji Yinhang Yewu Jinzhan Shunli (Xiamen International Bank Doing Well)*, People's Daily, Mar. 5, 1986. Another joint venture bank is China International Finance Limited, established by the Bank of China and four other foreign banks, each holding 20 percent of the equity interest. China International Finance Co. was scheduled to commence operation in fall 1986. See Xinhua News Agency press release, July 25, 1986, Shenyuan.

74. *Id.*

75. *Xiamen Guoji Yinhang Qibu Shunli (Xiamen International Bank Taking Off Smoothly)*, People's Daily, July 19, 1986, at 3.

founded.⁷⁶ Official permission for Chinese presence of foreign bank branches was granted in early 1985.⁷⁷ By early 1986 eighteen foreign banks had set up branches in Shenzhen, Xiamen and other SEZs.⁷⁸ A foreign branch is owned by the head office and does not constitute an independent entity. Thus, its assets, liabilities, and policies are those of the foreign head office. The branch is bound by Chinese law and the law of the foreign country where its head office is located, and is subject to Chinese tax and the relevant foreign tax. The branch may provide banking services and make loans based on the size of its head office without observing lending and investment limits in current Chinese banking law.⁷⁹

Foreign banks or foreign investors may establish an independent subsidiary bank or form a new bank with the head office in the SEZs. These options became possible in early 1985, when the government promulgated the new Chinese foreign banking law.⁸⁰ Since then no case has been reported. A subsidiary bank has most of the advantages of a branch. The subsidiary is an appropriate banking vehicle for those foreign banks whose branch activities are limited by domestic regulations. As an independent entity, the subsidiary is subject only to Chinese tax; in contrast, a branch is subject to both Chinese and home state tax.⁸¹ Additionally, a subsidiary may insulate the parent bank from risks and liabilities to which the subsidiary is exposed. A foreign bank with a branch in China may be sued in China, while a foreign bank having only a subsidiary bank in China probably cannot.

Direct banking business by Sino-foreign joint venture banks, foreign bank branches, or foreign subsidiary banks is currently limited to the four

76. The four foreign banks are: Hong Kong and Shanghai Banking Corp., Standard Chartered Bank (which operates in China under the name of "Chartered Bank"), Bank of East Asia, and Overseas-Chinese Banking Corp. These banks operated in China before 1949 and did not pull out when PRC was founded. Standard Chartered Bank has been in China for 127 years. Two of the four banks are Hong Kong banks, one is British, and the other is a Singapore bank. Wilson, *supra* note 6, at 25; *Alternative Financing Eyed to Attract Investment*, J. Commerce, Apr. 15, 1986, at 8C. Since the founding of the PRC, the Bank of China has maintained branches in London, Hong Kong, and Singapore. Thorn, *supra* note 6, at 58. Thus, mutuality and reciprocity are probably the reasons why these banks are given such a privilege.

77. See RGFB, *supra* note 67.

78. *More Room to Move—Not so Much to Develop*, FAR EASTERN ECON. REV., Sept. 11, 1986, at 90 [hereinafter *More Room to Move*]. Among the eighteen foreign bank branches, there is a Shenzhen. See Li Fang, *Waizi Yinhang Zai Shenyuan Tequi (Foreign Banks in Shenzhen Special Economic Zone)*, ECONOMIC REPORTER, June 9, 1986, at 27.

79. Article 9 of the RGFB set up lending and investment limits for foreign banks. It applies, however, according to its plain language, only to lendings and investment by foreign banks with head offices in the SEZs or joint venture banks. See RGFB, *supra* note 67.

80. See *id.*

81. The distribution of dividends, however, by the subsidiary to the head office abroad is usually taxed by the country where the head office is incorporated as income for the head office.

SEZs.⁸² Foreign banks or joint venture banks must obtain prior approval of the Chinese authority for each specific type of banking business.⁸³ Generally, except for representative offices of foreign banks, the scope of business permitted for foreign bank branches, subsidiaries, and Sino-foreign joint venture banks is identical. They are functionally similar to "depository agencies" or "limited branches" under California law. They may not engage in as wide a range of businesses as that permitted for Chinese banks. The current experimental practice may eventually lead to foreign bank expansion of services to other areas. As the Chinese leader pointed out, China at present does not have adequate experience of regulating foreign banking business, and this necessitates an experiment on a small scale.⁸⁴

III. Foreign Bank Representative Offices (ROs)

The presence of foreign financial institutions in China on a long term basis occurred in the late 1970s. In 1980, the State Council issued regulations which legitimized the existing practice and also set out rules and procedures governing the establishment and operation of ROs.⁸⁵ In 1983, the PBOC promulgated special regulations governing the establishment of ROs for foreign financial institutions.⁸⁶ During subsequent years, Chinese government agencies and regional governments also issued regulations and rulings on tax, registration, and other issues of ROs in China. The following section discusses Chinese laws and practices regarding the establishment and regulation of foreign bank ROs in China.

A. ESTABLISHMENT OF ROs

Foreign banks doing business in China on a long term basis are strongly advised to establish an RO. Maintaining a constant presence without legitimizing it in the form of an RO may cause several legal consequences.⁸⁷

82. Chinese law concerning direct foreign banking applies only to the four SEZs. See RGFB, *supra* note 67. Chinese leaders have also made clear that presently foreign banks are allowed only in the four SEZs. People's Daily, Oct. 18, 1985; *Foreign Bank Branches Ruled out by China Outside Special Zones*, Asian W. St. J. Weekly, June 17, 1985, at 3.

83. RGFB, *supra* note 67, art. 5.

84. Chen Maohua, Chairman of the PBOC, *Talks to a Group of Japanese Journalists*, Xinhua News Agency, News Release, Oct. 17, 1986, Beijing.

85. Interim Regulations of the State Council Governing Representative Office of Foreign Enterprises (IRRO), effective Oct. 30, 1980, *reprinted in CHINA INVESTMENT GUIDE 1984/85*, *supra* note 4, at 549-551.

86. APERO, *supra* note 66.

87. The failure to register with Chinese authorities while maintaining a presence in China on a long-term basis may warrant the imposition of penalties up to 10,000 yuan. Although no foreign bank has yet been penalized for this reason, quite a few other foreign enterprises

To set up an RO in China, a foreign bank must file an application with the PBOC and register with the State Administration of Industry and Commerce. It also must process other documents with the Public Security Bureau and several other governmental agencies.

1. Application

To set up an RO in China, a foreign bank must file a written application with the PBOC.⁸⁸ The application shall be addressed to the President of the PBOC and signed by the Chairman of the Board of Directors or the President of its head office.⁸⁹ The application must be prepared in the name of the foreign bank and may be submitted either directly to the PBOC or through other Chinese financial institutions.⁹⁰ When an RO is to be established in Chinese cities other than Beijing the application may be filed with local branches of the PBOC.⁹¹

An application for an RO must be accompanied by the following documents: a standard application form issued by the PBOC duly filed; a copy of an official business license or business registration certificate issued by the pertinent authorities of the country or region where the applicant is located; the articles of association of the head office; a list of the members of the board of directors or other similar body; the most recent annual report, setting forth the assets and liabilities and profits and

have been fined for failure to do so. A Hong Kong newspaper reported that in September 1985, twenty-seven foreign enterprises from Hong Kong and Macao were fined in Guangzhou. *Jiyou Shi Niandai (The Nineties Monthly)*, Hong Kong, Dec. 1985, at 65.

Foreign bank representatives present in China for business purposes for half a year or less need not register as ROs. If their presence in China exceeds six months, but their business may be completed within a short period of time, they need not register. They are, however, required to present a document issued by their Chinese sponsors to support their claims and to post such a document to the registration authority for record. *Supplement Circular of the State Administration of Industry and Commerce on the Registration of Foreign Representative Offices in China*, [hereinafter *Supplement Circular*], reprinted in GUONEI JINGJIFA XUANBIAN (hereinafter *SELECTED ECONOMIC STATUTES*) 122-24 (Economic Law Training Center of Shanghai for Industrial, Transportation, and Commerce, Mar. 1985).

88. APERO, *supra* note 66, art. 4.

89. *Id.*

90. *Id.*

91. *Id.* Article 2 of the APERO reads: "Foreign financial institutions may, if necessary, apply to set up ROs in Beijing or the SEZs. After setting up ROs in Beijing, they may apply to establish ROs in other cities if necessary." This provision contains two implications. First, foreign banks may initially establish ROs only in the SEZs and Beijing. Second, foreign banks may not establish RO in any other cities unless they first have set up ROs in Beijing. This is not consistent with Chinese foreign banking practice. Presently, foreign banks are allowed to establish ROs initially in cities other than Beijing and SEZs. For instance, Kogyo Bank and Nikko Securities Co. each set up its only RO in Qingdao. *Other Foreign Banks in China*, CHINA BUS. REV., Jan.-Feb. 1986, at 27. Additionally, many more foreign banks have had their ROs in other cities after they had an RO in the SEZs, instead of having an RO in Beijing. *Id.*

losses of the business; a certificate of power of attorney signed by the chairman of the board of directors or by the president for the chief representative of the RO; and resumes of the chief representative and other representatives.⁹² These documents must be provided either in Chinese or in English. An English or Chinese translation must be attached if any of the documents listed above is written in any other language.⁹³ The PBOC will then examine the documents and approve the application. The approval for an RO by the PBOC is effective for three years.⁹⁴ A request for extension should be submitted within thirty days before the expiration date, and should be signed by the chairman of the board of directors or the president of the head office.⁹⁵ Upon the examination of the application, the PBOC may grant extension for another three years,⁹⁶ without limitation on the number of extensions.⁹⁷

2. Registration

Registration is in the charge of the State Administration of Industry and Commerce (State AIC). State AIC directs various regional AICs to administer registrations within their pertinent jurisdictions. Since 1980, State AIC has issued several regulations and internal rulings governing the registration of ROs. Additionally, some regional AICs enacted regulations applicable to the registration of ROs in special areas.⁹⁸ Registration will accord ROs certain privileges, such as entitlement of the RO to a business license and of its employees to residency certificates. Registration also enables ROs to import office equipment and personal belongings.

As a general requirement, banks must register with the AIC in the province or special administrative city (i.e., Tianjin, Beijing, and Shanghai) where the RO is located. According to the administration procedure issued by the State AIC and approved by the State Council and a supplementary circular, a foreign bank shall file with the pertinent AIC the certificate of approval issued by the PBOC and other relevant documents listed in article 3 of the 1980 State Council's Interim Regulations for the Administration of Foreign Enterprises' Resident Representative Offices, as well as the 600 yuan registration fee.⁹⁹ These documents are similar

92. APERO, *supra* note 66, art. 4.

93. *Id.*

94. *Id.* art. 7.

95. *Id.*

96. *Id.*

97. *Id.*

98. For example, on April 1, 1982, Shanghai AIC issued a *Circular on the Registration of Representative Offices of Foreign Enterprises*, reprinted in SELECTED ECONOMIC STATUTES, *supra* note 87, at 133.

99. Administration Procedure of the State Administration of the Industry and Commerce

to those required for filing an application with the PBOC. If State AIC determines, after examination, that the documents filed conform to the regulations, then it will register the name and address of RO, the number and names of the representatives, the scope of business, and the term of residency.¹⁰⁰ Then it will issue a registration certificate and representative identifications.¹⁰¹

The registration issued by State AIC is effective only for a year.¹⁰² The application for extension must be filed within thirty days before the expiration of the registration.¹⁰³ Such an application must be accompanied by a Chinese version of the annual business activity report prepared by RO and a fee of 300 yuan.¹⁰⁴ The State AIC will examine the application and issue a new registration certificate. Any change in the name or address of an RO, the names of the representatives, the number of representatives, or the scope of business should be communicated to the pertinent AIC, together with evidence of approval by the PBOC.¹⁰⁵ State AIC will then process the relevant changes in the registration, the fee for which is 100 yuan.¹⁰⁶ Failure to comply with this provision may result in a fine up to 5,000 yuan or the revocation of the registration.¹⁰⁷

3. *Procedures for Other Governmental Agencies*

After registration, the foreign bank must apply to the Public Security Bureau for a residency permit for the representatives and other foreign employees of the RO.¹⁰⁸ The documents required are the registration certificate issued by the pertinent AIC and the certificate of approval issued by the PBOC.¹⁰⁹ The Public Security Bureau will examine the documents and issue a certificate of residency to each of the representatives and foreign employees. The certificate of residency will be effective as long as the certificate of registration remains valid, up to one year.¹¹⁰ The certificate of residency may be renewed upon application.¹¹¹

for the Registration of Foreign Representative Offices, [hereinafter *Administration Procedure for Registration*], approved by the State Council and promulgated by the SAIC Mar. 5, 1983. See *Supplement Circular*, *supra* note 87, arts. 7 and 10.

100. *Id.* art. 8.

101. *Id.*

102. *Id.* art. 11.

103. *Id.*

104. *Id.* See also *Supplement Circular*, *supra* note 87, art. 10.

105. *Administration Procedure for Registration*, *supra* note 99, art. 12.

106. *Supplement Circular*, *supra* note 87, art. 10.

107. *Administrative Procedure for Registration*, *supra* note 99; art. 15.

108. *Id.* art. 5.

109. *Circular of the Ministry of Public Security Regarding the Visa and Travels of the Personnel of the Foreign Representative Office* [hereinafter *Circular Regarding Visa and Travels*], Apr. 6, 1981, No. 48. See *supra* note 87, art. 2.

110. *Id.*

111. *Id.*

RO is required to open a bank account with Bank of China.¹¹² In addition, it must register with the tax bureau of the local government before commencing operation.¹¹³

B. REGULATION OF ROs

ROs of foreign banks are required to comply with Chinese law in every aspect of business operation. The Chinese law regulating foreign bank ROs is discussed briefly in this section.

1. *Personnel Management*

Chinese law limits the number of representatives which may be stationed in an RO in China. According to a regulation governing registration, the number of representatives of an RO of a foreign bank may not exceed four if the RO is in Beijing, and three if it is located in the SEZs.¹¹⁴ Special permission of the PBOC must be obtained if more representatives are needed.¹¹⁵ The appointment of a representative, especially the chief representative, must be approved by the PBOC before the representative may assume the position.¹¹⁶ Changes of representatives must also be approved by the PBOC.¹¹⁷ If the chief representative takes leave for a period exceeding thirty days, the chief representative must designate another person to take the responsibility.¹¹⁸ The written appointment must be submitted to the PBOC for record.¹¹⁹

Chinese law expressly prohibits an RO from employing citizens of a third country.¹²⁰ In practice, however, the Chinese authorities acquiesce in the hiring of citizens of the third country, and apparently take no action against this practice. An RO may employ as many Chinese citizens as it needs.¹²¹ Chinese citizens must be hired through Chinese foreign service agencies or other Chinese labor service institutions appointed by the

112. Administration Procedure for Registration, *supra* note 99, art. 6.

113. To register with the Chinese Tax Bureau for an RO, a foreign bank must provide a description of office activities for the Tax Bureau to determine the office's tax status, a letter from the head office, and/or a pay stub to verify personal income for individual tax purposes. Brehm, *Setting Up Shop in Shanghai*, CHINA BUS. REV., Nov.-Dec. 1985, at 13.

114. APERO, *supra* note 66, art. 9.

115. *Id.*

116. *Id.*

117. *Id.* art. 11.

118. *Id.* art. 12.

119. *Id.*

120. *Circular Regarding Visa and Travel*, *supra* note 109, art. 5.

121. APERO, *supra* note 66, art. 10.

Chinese government.¹²² The employment of Chinese is not subject to the approval of the PBOC. ROs must report, however, to the PBOC or its branches for record.¹²³

2. *Business Activities*

Chinese law limits the scope of business activities by ROs. Generally, an RO may engage in negotiations, liaisons, consultations, or other services not directly related to profit-making.¹²⁴ A lending arrangement is usually negotiated through an RO in China and booked from the head office abroad. As a rule, an RO may not receive deposits or engage in other direct banking business. In practice, an RO's business goes beyond acting solely as the liaison office for its head office. ROs of foreign banks have very actively represented other foreign enterprises to establish business contacts in China or to provide consultation or negotiation services for business entities other than their own head offices.¹²⁵ Through these activities, an RO receives commissions or other service fees and also locates financial opportunities for itself.¹²⁶ In addition, an RO also represents domestic Chinese enterprises in finding business or business opportunities abroad.¹²⁷

122. *Id.* See also *Circular Regarding Visa and Travel*, *supra* note 109. A comment from a newspaper article on setting up ROs in Shanghai states:

Hire local staff: The hiring of local Chinese employees to staff Shanghai office is tightly controlled by the Shanghai branch of FESCO. Office assistants, secretaries, drivers, cooks, maids, and technical personnel cost from 800 to 1,500 per month depending on the candidate's qualifications. Employees receive a percentage of the fee as wages. FESCO selects the candidates, and the hiring company has the opportunity to interview, approve the selection, or request another applicant. Hiring local employees directly without going through FESCO is currently a topic of heated debate between foreign companies and the Shanghai authorities. Companies that have succeeded in hiring staff outside the FESCO monopoly have done so only after arduous negotiations and the intervention of highly placed local officials. These companies continue to face bureaucratic opposition for circumventing the FESCO system.

Braham, *supra* note 113, at 13.

123. APERO, *supra* note 66, art. 10.

124. *Id.* art. 8.

125. See *supra* note 71 and accompanying text. Foreign banks also expressly hold themselves out as providers of consulting services. An advertisement by a foreign bank RO in China reads as follows: "For sound investment advice, invest in a telephone call now . . . so if you need advice or information call our representative today." CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 224-25.

126. Interviews with foreign bankers confirm that foreign banks usually receive a fee for consultation or other services provided by their ROs in China, though payment is usually made abroad directly to the head offices.

127. A Chinese official report in early 1986 reads:

According to the statistics, there are 21 ROs of foreign banks. They take the advantage of their broad overseas connections to introduce Chinese enterprises to many foreign investors. They also provide a lot of information and consultation service. Some RO helped Chinese enterprises establish business contacts with its head office or other branch

3. *Supervision of ROs*

An RO is required to open a bank account with Bank of China and comply with China's foreign exchange regulations.¹²⁸ Thus, Bank of China apparently supervises the financial inflow and outflow of ROs. Additionally, Chinese law expressly authorizes the PBOC to supervise and administer the business activities of ROs. An RO is required to submit to the PBOC an annual report before January 15 of each year.¹²⁹ The annual report must accurately reflect the business activities of the RO in China in the year covered, and must be written in both English and Chinese.¹³⁰ The PBOC is authorized to investigate and dispose of any violation of the relevant Chinese regulations by the RO.¹³¹ Additionally, Chinese law authorizes State AIC to supervise the RO and to exercise limited police power. State AIC may investigate and supervise business activities of the RO in China.¹³² If an RO violates the registration requirements, State AIC may, at its discretion and in accordance with the nature of the violation, issue a warning, impose a fine less than 5,000 yuan, or revoke the registration certificate.¹³³ If an RO engages in business activities in violation of Chinese law, such as conducting a direct profit-making business, State AIC is empowered to issue an injunction and impose a fine of no more than 20,000 yuan.¹³⁴

IV. Foreign Banks, Joint Venture Banks, and Foreign Bank Branches

Foreign investors are allowed to engage in direct banking business in China by establishing foreign banks with head offices in China, foreign bank branches, or Sino-foreign joint venture banks. Currently, foreign banks, foreign bank branches, and joint venture banks are allowed only in the four SEZs. This section discusses the procedure for the establishment of foreign banks, foreign bank branches, and joint venture banks in compliance with regulations of the foreign banking business.

offices, and arranged for loan agreements. Their work has been very successful. *People's Daily*, Jan. 27, 1986.

128. *APERIO*, *supra* note 66, art. 6.

129. *Id.* art. 15.

130. *Id.*

131. *Id.* art. 17.

132. *Administration Procedure for Registration*, *supra* note 99, art. 14.

133. *Id.* art. 15.

134. *Id.* No instance of any foreign bank having been fined has been reported under this provision.

A. ESTABLISHMENT OF FOREIGN BANKS,
FOREIGN BANK BRANCHES AND
SINO-FOREIGN JOINT VENTURE BANKS

To establish branches in the SEZs, a foreign bank must file an application with the PBOC.¹³⁵ The application sets forth the name of the branch to be set up, the amount of operating funds allocated to it, and the type of banking business to be transacted.¹³⁶ The application also includes resumes of the key officers and a power of attorney.¹³⁷ The application must be notarized and signed by the president or the chairman of the board of directors of the head office.¹³⁸

The applicant must also submit the charter of the association of the head office, a list of the names of the directors, a copy of the business license issued by the competent authority of its home country, and a written guarantee of the head office regarding taxes and liabilities.¹³⁹ For the PBOC to ascertain the financial status of the applicants, the law requires the applicant to file balance sheets, profit and loss statements, and business reports for the three consecutive years prior to the application.¹⁴⁰

To form foreign banks with a head office in the SEZs, a foreign investor needs to file with the PBOC a written application setting forth the name of the bank, registered capital and paid-in capital, a list of the names of the key officers, and the types of banking business applied for.¹⁴¹ The applicant shall submit, along with the application, the charter of the associations, and the name list of the proposed chairman, vice-chairman, and other members of the board of directors.¹⁴² The applicant must also file a notarized statement documenting its assets and liabilities.¹⁴³

The procedure for establishing a Sino-foreign joint venture bank is slightly different. All the parties to a joint venture bank must file an application with the PBOC setting forth the name of the joint venture bank, the names of the parties to the joint venture, details of registered capital and paid-in capital, the contributions of the parties, the name list of the key officers, and the types of business applied for.¹⁴⁴ The parties to the joint venture bank must jointly prepare a feasibility study and submit

135. RGFB, *supra* note 67, art. 5, para. 1.

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. *Id.* art. 5, para. 2.

142. *Id.*

143. *Id.*

144. *Id.* art. 5, para. 3.

it together with the application.¹⁴⁵ The parties also must file the draft letter of intent, the draft joint venture contract, the charter of the association, and the list of the names of the chairman, vice chairman, and members of the board of directors.¹⁴⁶ The joint venture bank is a limited liability company under Chinese law.¹⁴⁷ Each party to a joint venture is liable only within the limit of its contributions. Ordinarily, the equity interest of foreign parties shall not be less than 25 percent.¹⁴⁸

Upon the receipt of the application and other required documents, the PBOC will review and approve the application in accordance with "the need of economic development in the SEZs and the principle of reciprocity."¹⁴⁹ There are no further detailed rules as to the criteria by which the PBOC approves or disapproves an application. The PBOC possesses complete discretion in making the determination. Furthermore, the decision of the PBOC is apparently final, subject neither to judicial review nor higher level of administrative reconsideration. The Chinese law does not specify the time limitation within which the PBOC shall render its determination.¹⁵⁰ Practice has shown so far that the approval process by the PBOC is fairly expedient.¹⁵¹

After obtaining the approval of the PBOC, the State Administration of Foreign Exchange Control will issue a special license for the applicants to engage in foreign exchange business.¹⁵² The foreign bank or joint venture bank must also register with State AIC within thirty days after its application is approved and obtain a business license.¹⁵³ Foreign banks

145. *Id.*

146. *Id.*

147. The Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment [hereinafter Joint Venture Law], adopted by the second session of the Fifth National People's Congress in July 1979, *reprinted in CHINA INVESTMENT GUIDE 1984/85*, *supra* note 4, at 379-81. Article 4 reads: "A joint venture shall take the form of a limited liability company. . . . The profits, risks and losses of a joint venture shall be shared by the parties to the venture in proportion to their contributions to the registered capital."

148. Article 4 of the Joint Venture Law provides that the proportion of the investment contributed by the foreign participants shall in general not be less than 25 percent. *Id.*

149. RGFB, *supra* note 67, art. 4.

150. Chinese laws have begun to give some attention to the procedural rights of those affected. The Joint Venture Law provides that an application for joint ventures must be either rejected or accepted within three months. *See* art. 3. A similar provision is also found in the technology transfer regulations of the State Council, which provide that if the authority fails to respond within six months after the application is filed, the application will be regarded as automatically approved. Regulations of the People's Republic of China for the Administration of Technology Import Contracts, art. 4, *reprinted in CHINA BUS. REV.*, Nov.-Dec. 1985, at 39. Surprisingly, the RGFB does not contain similar time limitations for the PBOC to consider the application and extend the approval.

151. According to a Chinese official newspaper report, the PBOC approved five foreign banks to set up branches in the SEZs within two months (August to October 1985). *People's Daily*, Oct. 18, 1985.

152. RGFB, *supra* note 67, art. 4.

153. *Id.* art. 8.

or joint venture banks must open business within twelve months as of the date of approval, or the certificate of approval issued by the PBOC will automatically become ineffective.¹⁵⁴

After commencement of business, foreign banks and joint venture banks shall register with local tax bureaus within thirty days of the opening date.¹⁵⁵ Failure to process tax registration may subject foreign banks to a fine of up to 5,000 yuan.¹⁵⁶ The Ministry of Finance has issued special regulations governing tax registration of foreign enterprises in China.¹⁵⁷ According to the regulations, a foreign bank must submit to the tax bureau a copy of its original application filed with the PBOC, together with a copy of the certificate of approval issued by the PBOC or the business license issued by State AIC.¹⁵⁸ In addition, foreign banks must file a standard registration form in triplicate in Chinese or in both Chinese and English.¹⁵⁹ Any later changes in the name of the institution, the scope of business, or the geographic location must be communicated within fifteen days to the tax bureau together with relevant approval documents by the competent authority which completes the appropriate changes in the registration.¹⁶⁰

Foreign banks and joint venture banks located in China are allowed to establish branches within the SEZs. They must, however, file an application that will be subject to approval of the appropriate branch office of the PBOC in the SEZs.¹⁶¹

B. CAPITALIZATION REQUIREMENT

Foreign banks with head offices in China and joint venture banks need to maintain a registered capital of no less than 80 million yuan, of which no less than 50 percent shall be paid-in capital.¹⁶² A foreign bank branch must have an operating fund allocated to it by the head office no less than 40 million yuan.¹⁶³ The capital required for foreign banks, joint venture banks, and branch offices must be maintained in the form of foreign

154. *Id.*

155. *Id.*

156. Foreign Enterprise Income Tax Law of the People's Republic of China (FEITL), reprinted in CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 437, arts. 35 and 44.

157. Interim Regulations on Tax Registration Regarding Commencement and Termination of Foreign Enterprises (IRT), General Tax Bureau of the Ministry of Finance, Mar. 4, 1982.

158. *Id.* art. 3.

159. *Id.* art. 5.

160. *Id.* art. 6.

161. RGFB, *supra* note 67, art. 5, para. 4.

162. *Id.* art. 7.

163. *Id.* According to the current official exchange rate, 40 million yuan is roughly a little over \$10 million.

currency.¹⁶⁴ The paid-in capital of foreign banks and joint venture banks and the operating fund of the foreign bank branch offices shall be made available within thirty days from the date when the establishment of banks or branches is approved.¹⁶⁵ The availability of the capital or funds also has to be verified by the public accountant registered in China.¹⁶⁶

This rigid capitalization requirement applies only to "banks" as such. Recent foreign banking practices show that the Chinese Government demonstrates some flexibility in applying this capitalization requirement. The recently established China International Finance Company is reportedly capitalized with \$7 million jointly provided by the Bank of China Shenzhen Branch, the Bank of East Asia, Nomura Securities, Sumitomo Bank, and Security Pacific Corporation.¹⁶⁷ The China International Finance Company is apparently a joint venture financial institution, but the \$7 million funding is far short of 80 million yuan, the minimum capitalization for joint venture banks. According to the joint venture agreement, the business to be conducted by the China International Finance Company includes "providing wholesale commercial banking service and investment banking service to the government agencies, state-owned enterprises, Sino-foreign joint ventures, wholly-foreign-owned enterprises located in the Shenzhen Special Economic Zone and other inland areas."¹⁶⁸ The Chinese official newspaper, People's Daily, called it a "Sino-foreign joint venture bank."¹⁶⁹ The same newspaper report also stated that "this bank, in addition to conducting regular banking service, also gathers funding for China's economic development."¹⁷⁰ These reports indicate that this joint venture financial company differs little from a joint venture bank in terms of business operations. A joint venture financial company is apparently not subject, however, to the limit of the capitalization imposed on a joint venture bank. The development of financial companies seems to provide a novel alternative in the Chinese-foreign banking practice.

Foreign banks and joint venture banks taking deposits from customers need to post a reserve with the branch office of the PBOC located in the

164. *Id.* The RGFB does not provide which foreign currency shall be maintained, whether that currency shall be matched in any way to the operating activities and foreign currency exposures of the bank, or whether a bank may switch part of the capital into different currencies depending on its foreign currency exposures. See *China's New Banking System*, INT'L FIN. L. REV., July 1985, at 33.

165. RGFB, *supra* note 67, art. 7.

166. *Id.*

167. Shenyuan Chenli Zhongwai Hezi Caiwu Gongsi: (*Sino-Foreign Finance Company Being Established in Shenzhen*), People's Daily, July 26, 1986, at 1.

168. *Id.*

169. Zhongwai Hezi Yinghang Jiangzai Shenyuan Jianli (*Sino-Foreign Joint Venture Bank Will Be Set Up In Shenzhen*), People's Daily, Sept. 23, 1986, at 1.

170. *Id.*

SEZs.¹⁷¹ The same requirement is also made for domestic specialized banks that take deposits from customers.¹⁷² The Chinese law does not specify a rigid rule in determining the amount of the reserve. In the domestic banking context, the central bank may fix the reserve and adjust it from time to time as a means to control the circulation of currency.¹⁷³

C. SCOPE OF FOREIGN BANKING BUSINESS

Chinese law specifies the types of business in which foreign and joint venture banks may engage. These include loans and deposits, inward remittance and foreign exchange collections, export transactions, outward documentary bills, discounting bills, and foreign exchanges.¹⁷⁴ They also include security transactions, investments, guarantees, trusts, safety deposit boxes, credit investigations, and consultations.¹⁷⁵

Foreign banks and joint venture banks must specifically apply for the type of banking business that they intend to transact.¹⁷⁶ The application is filed together with the initial application for establishment. The PBOC will review the application and may allow foreign banks or joint venture banks to engage in some or all of the business activities listed above.¹⁷⁷ Chinese law also states that the list of activities is not exhaustive.¹⁷⁸ Foreign banks or joint venture banks may transact other banking or banking-related business upon approval of the PBOC.

D. REGULATION OF FOREIGN BANKING BUSINESS

Chinese foreign banking law and practice have only recently started to develop. Although foreign banks are now allowed to engage in a variety of banking businesses within limited geographic areas, a corresponding body of law regulating complicated banking transactions has not developed. The law in its present state governs only major aspects of foreign

171. RGFB, *supra* note 67, art. 11.

172. IBR, *supra* note 10, art. 37.

173. *Id.* No officially published information exists about the amount of reserve that the PBOC practically requires from the specialized banks. According to a report in the China Business Review, the Industrial and Commercial Bank of China was required to turn 20 percent of its enterprise deposits and 40 percent of its savings deposits over to the PBOC as reserves. See Brotman, *supra* note 18, at 20.

174. RGFB, *supra* note 67, art. 6.

175. *Id.*

176. RGFB art. 5 requires that the application for establishment shall specify the type of banking business for which a foreign bank applies. Article 6 provides that the PBOC will approve, in accordance with the application, some or all of the banking businesses listed. *Id.* at arts. 5 and 6.

177. *Id.*

178. *Id.* art. 6, para. 12.

banking such as deposits, loans, investments, and interest. This section discusses these rules.

1. *Deposit Taking*

Foreign banks and joint venture banks are currently allowed to accept deposits from customers.¹⁷⁹ This privilege, however, is limited by Chinese law. Foreign banks and joint venture banks may accept deposits from enterprises located in the SEZs or abroad and owned by foreigners or overseas Chinese including Sino-foreign equity and contractual joint ventures.¹⁸⁰ They may also accept deposits from foreign individuals and from overseas Chinese in SEZs and foreign countries.¹⁸¹ Apparently, however, foreign banks and joint venture banks may not take deposits from Chinese enterprises or individuals.¹⁸² Deposits accepted from enterprises and individuals abroad may only be in foreign currency. Although Chinese law clearly provides that in all other instances, banks may accept deposits in Chinese and in foreign currency, foreign banks have not yet been allowed to conduct business in Chinese currency.¹⁸³

The law does not clearly provide whether foreign banks may receive deposits from joint ventures, foreign enterprises, and individuals in other parts of China outside the SEZs. The joint venture agreement of the recently established China International Finance Company approved by the Chinese Government clearly specifies that the scope of business of the bank extends to inland areas.¹⁸⁴ This seems to indicate that the banking business of foreign banks located in SEZs may extend to joint ventures and foreign entities or individuals in other areas of China.

2. *Loans*

Foreign banks and joint venture banks are allowed to make loans to domestic and foreign enterprises or individuals in the SEZs or abroad.¹⁸⁵

179. *Id.* art. 6, para. 10.

180. *Id.*

181. *Id.*

182. See *Shenzhen's First Foreign Bankers Learn that Privilege Doesn't Lead to Profits*, Asian Wall St. J. Weekly, Mar. 10, 1986, at 18.

183. RGFB, *supra* note 62, art. 6, para. 11; see also *More Room to Move*, *supra* note 73, at 95.

184. See *supra* note 158 and accompanying text.

185. RGFB, *supra* note 67, art. 6 provides the types of business in which foreign banks may be allowed to engage. Paragraph 1 reads, "loans and bills discount in both Chinese and foreign currencies." Unlike the provisions regarding deposit taking, this provision does not limit the scope of potential customers. Presumably, foreign and joint venture banks may extend loans to individuals and enterprises, including Chinese domestic enterprises and individuals. Furthermore, this provision fails to provide geographic limitations on the scope of business. Paragraph 11 expressly allows foreign banks to extend loans to customers abroad; it does not provide whether foreign banks may extend loans to customers outside the SEZs in other parts of China.

The law does not clearly provide whether foreign banks or joint venture banks may extend loans to businesses or individuals in other parts of China outside the SEZs.¹⁸⁶ Logically, however, since even foreign banks located overseas may extend credit to Chinese companies and finance Chinese projects, there is no reason why foreign banks or joint venture banks located in China may not do the same.

Chinese law contains a lending limit. Generally, a foreign bank with its head office in China or a joint venture bank may not lend to one enterprise in the SEZ in an amount exceeding 30 percent of its paid-in capital plus its retained reserve.¹⁸⁷ This requirement is apparently intended to prevent overexposure to credit risk from any one borrower. This lending limit is substantially higher than that imposed in some leading western countries, which is usually 15 percent of the bank's capital funds.¹⁸⁸ In Chinese law, the lending limit is imposed with respect to loans to a single enterprise.¹⁸⁹ Presumably, the lending limit would not apply to lendings to governmental agencies other than enterprises as such. The banking law does not define what constitutes a "single enterprise." Thus, whether a wholly owned subsidiary is considered part of the parent enterprise, and whether, as in the United States, a bank must aggregate loans to the parent with loans to the subsidiary for purposes of the lending limit is unclear.¹⁹⁰ This issue will be clarified as Chinese foreign banking practice progresses. Note that the phrasing of the current Chinese law suggests that the lending limit is effective only with respect to loans to enterprises in the SEZs;¹⁹¹ whether loans to offshore borrowers will be subject to this lending limit is unclear. Additionally, the lending limit is imposed only on joint venture banks and foreign banks with head offices in China.¹⁹² Presumably, foreign bank branches will not be affected by the lending limit.

3. *Investment*

Foreign banks appear to be permitted to engage in direct investment in the SEZs. Leasing companies and other similar enterprises with direct participation of foreign banks have already been established.¹⁹³ The Chinese

186. *Id.*

187. *Id.* art. 9.

188. United States banking law imposes a lending limit of 15 percent of the bank's capital funds to a single borrower. See 12 U.S.C. § 84 (1982).

189. RGFB, *supra* note 67, art. 9.

190. Nichols, *Legal Issues in International Lending—General Considerations*, in ROUSAKIS, *INTERNATIONAL BANKING: PRINCIPLES AND PRACTICES* 165 (1983).

191. RGFB, *supra* note 67, art. 9.

192. *Id.*

193. For instance, Banque National de Paris, Hokkaido Takushoku Bank of Japan, and Hong Kong's Bank of Communications joined Bank of China and other Chinese entities to form a leasing company in China in early 1985. Asian Wall St. J. Weekly, Apr. 1, 1985, at 6.

law imposes a ceiling on the aggregate investment of foreign banks or joint venture banks. The total investment of a foreign bank with its head office in the SEZs or a joint venture bank in the SEZs may not exceed 30 percent of its paid-in capital plus retained reserve.¹⁹⁴ This limitation does not apply to foreign banks stationed abroad or foreign bank branches in China.

4. Interest Rate

Foreign banks and joint venture banks appear to be allowed to set interest rates with respect to deposit taking, loans, overdrafts, and commercial instrument discounts. Chinese law provides that foreign banks or joint venture banks may fix the interest rate with reference to the rate specified by the branch office of the PBOC in the SEZs.¹⁹⁵ The statutory language indicates plainly that such reference is noncompulsory.¹⁹⁶ To allow foreign banks to maintain freedom in setting interest rates seems consistent with Chinese banking policy: Chinese banking law allows Chinese domestic banks to maintain floating interest rates with certain limits to enhance competition among banks.¹⁹⁷

5. Profit

Chinese law distinguishes foreign bank branches from foreign banks and joint venture banks located in the SEZs with respect to profit allocation. Foreign bank branches may remit post-tax profit abroad without further obligation. Foreign banks and joint venture banks located in the SEZs must deduct from post-tax profit the following funds: reserve,¹⁹⁸ employee bonus and benefit, and business expansion. Chinese banking law does not provide further guidance as to the specific amount or proportion of each fund. These matters will probably be covered by the relevant part of the Chinese joint venture and foreign enterprise law.¹⁹⁹

194. RGFB, *supra* note 67, art. 9.

195. *Id.* art. 10.

196. Article 10 uses "may" instead of "shall." *Id.*

197. IBR, *supra* note 10, art. 42. Actually, in Shanghai, foreign bank branches are allowed to set their own interest rates with respect to loans and deposits to and from customers abroad, regardless of the rate set by the PBOC. *Shanghai Liberalizing Its Financial Policy, Foreign Bank May Set Interest Rate of Its Own*, People's Daily, Jan. 27, 1986.

198. Reserve funds are usually used to make up loss and increase capital. Implementing Regulations for the Chinese-Foreign Joint Venture, Law of the People's Republic of China, art. 87, promulgated by the State Council Sept. 23, 1983, *reprinted in* CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 381-96.

199. The Foreign Enterprise Law contains no specific provisions in this regard. The Implementing Regulations to be enacted, however, will probably answer this question. According to the joint venture law, the amount of each fund required will be determined by the Board of Directors. *Id.* art. 87. This provision will be applicable to joint venture banks.

6. *Reporting Requirements and Administration of Foreign Banking Business*

The PBOC regulates foreign banking business and has the authority to interpret relevant Chinese foreign banking regulations.²⁰⁰ Foreign and joint venture banks are required to file periodic reports with the branch office of the PBOC in the SEZs.²⁰¹ These reports include monthly balance sheets as of the end of the previous month which must be submitted before the tenth of each month.²⁰² They also include quarterly analytical statements setting forth deposits and loans, outward and inward remittances, settlements of import and export transactions, and investment items.²⁰³ These quarterly statements must be filed before the fifteenth day of the first month of each quarter.²⁰⁴ In addition, foreign and joint venture banks shall submit, before the end of March of each year, the balance sheets, profit and loss statements, statements of the balances of accounting items for the previous year, and an audit report by an accountant registered in the PRC.²⁰⁵

The PBOC has extensive regulatory power over foreign banking business. The branch office of the PBOC in the SEZs may examine the business and financial conditions of foreign and joint venture banks.²⁰⁶ The branch office may also issue orders requesting foreign and joint venture banks to submit banking-related data and information.²⁰⁷ It may send officers to investigate and examine the books and records of foreign and joint venture banks.²⁰⁸

The branch office of the PBOC in the SEZs may issue warnings and impose fines in the event that foreign and joint venture banks violate Chinese banking or financial law.²⁰⁹ The foreign and joint venture banks affected may appeal to the PBOC for final determination.²¹⁰ The PBOC has the ultimate power to revoke the business license or dissolve the foreign or joint venture bank in the event of gross violation of Chinese law.²¹¹ The statute contains no provision whether banks affected by the PBOC's decision may request judicial review.

200. IBR, *supra* note 10, art. 62; RGFB, *supra* note 67, art. 18.

201. RGFB, *supra* note 67, art. 12.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.* art. 13.

207. *Id.*

208. *Id.*

209. *Id.* art. 16.

210. *Id.*

211. *Id.*

V. Taxation of Foreign Banking Business

As a principle, foreign banking business is subject to Chinese tax upon its income derived from China. Tax consequences vary from case to case, depending on the structure of the foreign banking business. Direct lending from abroad is subject to Chinese foreign enterprise income tax upon the interest foreign banks charged to Chinese borrowers. Income from an RO in China may be subject to foreign enterprise income tax and consolidated industrial and commercial tax. Profit earned by foreign bank branches and foreign banks located in China is subject to foreign enterprise income tax and consolidated industrial and commercial tax. A foreign bank participating in a joint venture bank in China will be bound by Chinese joint venture tax law. In addition, foreign personnel serving in ROs, foreign bank branches, foreign banks, or joint venture banks located in China may subject themselves to Chinese personal income tax upon income from employment performed in China. The following section will discuss major Chinese taxes that affect foreign banking business in China.

A. FOREIGN ENTERPRISE INCOME TAX

The Foreign Enterprise Income Tax Law of the PRC (FEITL) came into effect on January 2, 1982.²¹² The FEITL was soon followed by implementing regulations promulgated by the Ministry of Finance in early 1982.²¹³ The FEITL distinguishes foreign enterprises with establishments from those not having establishments in China. Foreign enterprises having an establishment in China are taxed at a progressive rate ranging from 20 percent to 40 percent with respect to net profits depending on the amount of income plus 10 percent local tax.²¹⁴ Foreign enterprises without an establishment in China are taxed at a 20 percent flat rate on the gross income of certain categories of income having its source in China such

212. Foreign Enterprise Income Tax Law (FEITL), adopted at the fourth session of the fifth National People's Congress on Dec. 13, 1981, *reprinted in* CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 437-39.

213. Implementing Regulations of the Foreign Enterprise Income Tax Law of the People's Republic of China (IRFEITL), approved by the State Council and promulgated by the Ministry of Finance on Feb. 21, 1982, *reprinted in id.*, at 439-45.

214. FEITL, *supra* note 212, arts. 3 and 4. The tax table reads as follows:

Range of Income	Tax Rate (%)
Annual income below 250,000 yuan	20
That part of annual income above 250,000 and up to 500,000 yuan	25
That part of annual income above 500,000 and up to 750,000 yuan	30
That part of annual income above 750,000 and up to 1,000,000 yuan	35
That part of annual income above 1,000,000	40
The current exchange rate is approximately 3.7 yuan equals one United States Dollar.	

as dividends, interest, and royalties.²¹⁵ This general tax policy was later modified by special tax rules applicable within limited geographic areas or effective to categories of foreign business income primarily intended to create tax incentives for foreign investors.²¹⁶ The following section will discuss the impact of Chinese foreign enterprise income tax on various foreign banking businesses in China.

1. *Direct Lending from Abroad*

Foreign banks without presence in China may nonetheless make loans to the Chinese Government or to Chinese business entities. They may also deposit funds into Chinese banks. Their gross income from interest paid by Chinese borrowers will be generally subject to a 20 percent withholding tax.²¹⁷ However, the FEITL also exempts from tax foreign banks that grant Chinese banks preferential interest rates on deposits or loans.²¹⁸ A preferential interest rate usually means an interest rate lower than that prevailing in the international financial market.²¹⁹ This exemption also applies to foreign banks whose home country accords reciprocal treatment to Chinese banks.²²⁰

In 1983 the Ministry of Finance issued interim regulations which substantially broadened eligibility for tax exemptions or reductions with respect to interest income originating in China earned by foreign banks.²²¹ First, the regulations made a sweeping tax reduction from the 20 percent provided by the FEITL to 10 percent upon all interest income of foreign enterprises or banks sourced in China.²²² This preferential treatment applied to all loans or other agreements with Chinese business entities or government agencies concluded from 1983 to the end of 1985. In early 1986 the Ministry of Finance further extended this period of preferential

215. FEITL, *supra* note 203, art. 11.

216. See Interim Regulations of the Ministry of Finance Concerning the Reduction of or Exemption from Income Tax on Interest Derived from China by Foreign Enterprises [hereinafter Regulations on Tax on Interest], 1983, *reprinted in* CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 450-51; Interim Regulations of the State Council on the Reduction or Exemption of Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and 14 Coastal Cities [hereinafter Regulations for Coastal Cities], 1984, *reprinted in* ECONOMIC REPORTER, HONG KONG, Nov. 26, 1984, at 22-23; Interim Procedure of the Guangzhou Economy and Technology Development Zone Concerning Collection of Industrial and Commercial Tax, promulgated by the City Government of Guangzhou on Apr. 9, 1984, *reprinted in* ECONOMIC REPORTER, HONG KONG, Aug. 19, 1985, at 28-29.

217. FEITL, *supra* note 212, art. 11.

218. *Id.*

219. IRFEITL, *supra* note 213, art. 31.

220. FEITL, *supra* note 212, art. 11.

221. *Id.*

222. Regulations on Tax on Interest, *supra* note 216, art. 1.

treatment until the end of 1990.²²³ Second, foreign banks lending to Chinese banks or other Chinese investment and trust companies authorized by the State Council to engage in foreign exchange business are exempted from Chinese tax if the interest is charged at the international interbank call rate.²²⁴ Third, interest that foreign banks derive from their deposits in Chinese banks is tax exempt if the interest rate is lower than the rate on deposits in the home country of the foreign banks making deposits.²²⁵ Finally, foreign banks are tax exempt on interest income from their lending to the China National Offshore Oil Corporation if the interest rate does not exceed the interbank call rate.²²⁶ To obtain tax benefits under this regulation, foreign banks must request the pertinent Chinese party to the transaction to apply to the Chinese tax bureau and file the relevant contracts and other documents.²²⁷

In 1984 the Chinese Government further liberalized its tax policy towards foreign business. According to the State Council's interim regulations promulgated in late 1984, in addition to the tax exemptions discussed above, the foreign enterprise income tax on the interest derived by foreign banks from lending to China is further reduced to a 10 percent flat rate.²²⁸ This preferential tax treatment applies to all foreign banking transactions with Chinese enterprises or governmental agencies from the four SEZs and fourteen coastal cities including newly established Economic and Technological Development Zones. In addition, foreign banks may apply to the local government for a complete tax exemption if the terms of the loan are preferential to Chinese borrowers.²²⁹ Recently, some local governments further broadened the preferential treatment to facilitate and encourage foreign banking business.

The above rules also apply to foreign bank loans to other foreign banks located in China or to foreign bank head office loans to branches located in China. Shenzhen city government recently promulgated supplementary tax regulations providing guidelines in this area.²³⁰ The supplementary regulations allow exemption from withholding tax on interest payments made by foreign banks in the Shenzhen SEZ to other foreign banks abroad if the interest rate is equal to or less than that prevailing for international

223. *Id.* See also *People's Daily*, July 28, 1986, at 1.

224. Regulations on Tax on Interest, *supra* note 216, art. 2.

225. *Id.*

226. *Id.*

227. *Id.* art. 5.

228. See Regulations for Coastal Cities, *supra* note 216, ch. 1, para. 4; ch. 2, para. 4; and ch. 3, para. 3.

229. *Id.*

230. For detailed discussion on these supplementary regulations, see *People's Daily*, May 21, 1986, at 3.

interbank loans. The regulations also make clear that an interest payment from a branch office in the Shenzhen SEZ to its head office is subject to withholding tax unless the interest rate is equal to or less than that prevailing in international interbank loans. The regulations further allow an exemption from withholding tax on interest until 1995 for all offshore customers who maintain deposits in foreign banks located in the Shenzhen SEZ.

2. *Foreign Banking Representative Offices*

Foreign banks' ROs are affected by Chinese foreign enterprise income tax in two major respects. First, interest earned by foreign banks on their loans to China which were arranged through their ROs in China is taxed at a substantially lower rate than that earned by direct loans from foreign banks without establishments in China. Second, income of foreign banks' ROs from consultation or liaison services is subject to the foreign enterprise income tax.

As previously discussed, the Chinese FEITL distinguishes foreign companies with establishment in China from those without, and taxes the former at a progressive rate and the latter at a flat tax rate.²³¹ Since the progressive tax is imposed on net profit and the flat rate tax on gross income, the seemingly higher progressive tax rate often results in a substantially lighter tax burden. Chinese law makes clear that ROs are considered establishments.²³² In practice, Chinese authority distinguishes among the ROs and treats some as establishments and others as not, depending on the nature of the services provided.²³³

In 1983 the Ministry of Finance issued a letter ruling clarifying the tax status of ROs of foreign banks.²³⁴ According to the letter, interest income

231. See *supra* text accompanying notes 213-15.

232. "Establishment" mentioned in the FEITL means organizations and places, which "mainly" include management offices, branches, or representative offices. IRFEITL, *supra* note 213, art. 2.

233. The tax administration's current administrative posture suggests that "establishment" will not be interpreted as broadly as the statute and regulations might seem to allow, but rather will be interpreted in a manner akin to the concept of a "permanent establishment" commonly embodied in tax treaties. In other words, the Chinese will require a high order of presence or activity in China before concluding that an "establishment" exists. For example, representative offices that are characterized as engaged in information-gathering or liaison activities, or independent agents are unlikely to be regarded as "establishments," a position in accord with that of many tax treaties.

Gelatt & Pomp, *China's Tax System: An Overview and Transactional Analysis*, in FOREIGN TRADE, INVESTMENT AND THE LAW OF THE PEOPLE'S REPUBLIC OF CHINA 46 (Moser ed. 1984).

234. Letter Ruling of the Ministry of Finance Concerning Tax on Interest Arising from Loan Agreements Negotiated by Representative Offices of Foreign Banks, Apr. 11, 1983.

originating in China earned by a foreign bank will be taxed at a progressive rate as provided in the FEITL if the foreign bank has an RO in China and the RO has directly participated in the conclusion of the relevant loan agreement with the Chinese borrowers.²³⁵ The foreign bank is allowed to deduct the relevant cost and expenses incurred therefrom and is taxed only on its net profit.²³⁶ The regulations note the complexity in computation and difficulty in verification. It is recommended as an interim measure that 15 percent of the interest income be deemed the net profit and be taxed.²³⁷ The progressive tax rate ranges from 20 percent to a maximum 40 percent. Adding the 10 percent local tax, the maximum effective tax rate on gross income is, therefore, only around 6 percent, compared with 10 percent minimum tax rate for interest income derived from a loan arranged without the help of the RO.²³⁸

Foreign banks' ROs may also provide consultation and liaison services for customers and receive some compensation.²³⁹ The FEITL does not clearly provide that this compensation is subject to Chinese tax. In April 1985 the Ministry of Finance issued the interim regulations which expressly extend the application of the FEITL to compensation received by an RO for intermediary services.²⁴⁰ According to the interim regulation, commissions, fees, and other service charges received by an RO for the services performed within the territory of the PRC will be subject to foreign enterprise income tax, whether those fees are charged to the client of the head office of the RO, its own clients, or other business entities.²⁴¹ The charges or fees for services performed outside Chinese territory on behalf of Chinese domestic enterprises are exempt from tax.²⁴² Similar

235. *Id.*

236. *Id.*

237. *Id.*

238. Treatment of ROs of foreign banks as establishments and taxing them at a progressive rate partially relieves the tax burden on foreign banks. The letter stated:

According to tax law, interest from loans shall be levied at 20 percent flat rate. It is the common understanding that this way of calculating tax would impose heavier tax burden than the tax on the net profit. In order to absorb more foreign capital for construction, we need to adopt a more liberal tax policy and take flexible actions to ensure that lower tax is imposed. That is the reason why we decide to accord the RO the above treatment.

Id. (translation by author).

239. Foreign bankers interviewed acknowledged generally that they provide a variety of consultation and liaison services for customers outside and inside China and that they receive fees or compensation for the services. They all claimed, however, that the payment was made outside China to the head office.

240. Interim Regulations of the Ministry of Finance Concerning Imposition of Enterprise Income Tax and Consolidated Industrial and Commercial Tax on Foreign Representative Office (IRTRO), approved by the State Council on Apr. 11, 1985 and promulgated effective by the Ministry of Finance May 14, 1985, *reprinted in People's Daily*, May 15, 1985, at 2.

241. IRTRO, *id.* art. 2.

242. *Id.*

exemptions are also provided for services that RO performs within China for its own head office.²⁴³ The tax will be levied on the net profit. The taxpayer must supply records and document costs to determine the net taxable income; otherwise the tax authority will deem 10 percent of the gross income to be net profit.²⁴⁴ The tax will be imposed at a progressive rate from 20 percent to 40 percent, with a 10 percent local tax provided in the FEITL as discussed above. This will result in an effective maximum tax rate of less than 5 percent on the gross income. For the ROs located in the SEZs, the income tax is a flat 15 percent of the net profit, which probably results in an even lower effective tax rate.²⁴⁵ In addition, the interim regulations also impose a 5 percent consolidated industrial and commercial tax on the gross income.²⁴⁶ Although the tax rate is kept fairly low in effect, it is still possible that under this tax practice a foreign bank RO that sustains loss is deemed "profitable" and therefore subject to tax.

3. *Foreign Banks and Branches*

Business income of foreign banks and foreign bank branches is subject to Chinese foreign enterprise income tax. Foreign banks with head offices in China and foreign bank branches are taxed with respect to income originating inside China.²⁴⁷ As in the case of an RO, the tax is imposed on the net profit and at a progressive rate plus a 10 percent local tax.²⁴⁸ As discussed, the income tax in the SEZs is a 15 percent flat tax on the net profit. Since foreign banks and foreign bank branches are currently allowed, with few exceptions, only to engage in direct banking business in the SEZs, the 15 percent tax rate is in fact the applicable tax. The FEITL also contains a series of rules about deduction, depreciation, payment and regulation of foreign enterprise income tax, and these rules are discussed in the following section.

243. *Id.*

244. This deemed taxable income was initially 15 percent of the gross income. *See id.* art. 4. In October 1986 the Ministry of Finance reduced the rate to 10 percent. *See E. ASIAN EXEC. REP.*, Jan. 1987, at 26.

245. Regulations for Coastal Cities, *supra* note 216, ch. 1. ROs are deemed "enterprises" and may enjoy the 13% preferential tax rate. *See also infra* note 294.

246. Regulations for Coastal Cities, *supra* note 216. For detailed discussion of the consolidated industrial and commercial tax, *see* text accompanying notes 285-99.

247. The FEITL does not clearly provide whether foreign companies with establishments in China will be taxed with respect to their worldwide income or only on the income originating in China. Chinese tax officials have already indicated that only Chinese-source income is taxable under the FEITL. *See Gelatt & Pomp, supra* note 233, at 46. The Chinese language of article 1 of the FEITL also suggests this conclusion. *See supra* note 212.

248. *See supra* text accompanying notes 213-15.

a. Deduction and Depreciation

The taxable income is net profit that is determined through deducting cost from the gross income. The deductible items include losses sustained in the previous years' operation and taxes or duties other than income tax and administrative expenses.²⁴⁹ The FEITL also allows deduction of interest paid for loans or other normal borrowings.²⁵⁰ The implementing regulations, however, made clear that interest paid for capital is not deductible.²⁵¹ Neither the law nor the regulations clearly distinguish capital from normal borrowings. Generally "capital" refers to the initial investment in setting up the establishment or the later increase in the registered capital, particularly equity interest expenses. "Normal borrowing" means financing and refinancing in the ordinary course of business operations.²⁵²

Foreign bank branches may deduct reasonable expenses actually paid for the service provided by the head office abroad.²⁵³ These expenses, however, must be backed up by a certificate and voucher from the head office verified by the registered accountant and its written report.²⁵⁴ These expenses must also be examined and approved by the local tax bureau before they may be itemized. The supplementary tax regulations promulgated by the Shenzhen city government, to take effect July 1, 1986, allow foreign bank branches to include into costs and to make appropriate deduction for the interest paid to their head offices for operating funds allocated to them by the head office.²⁵⁵

Chinese law also allows deduction of reasonable entertainment expenses relevant to the business operation.²⁵⁶ The "reasonableness" is quantifiably defined in a progressive scale depending on the amount of net business income.²⁵⁷ The implementing regulations also list nondeduct-

249. FEITL, *supra* note 212, art. 6; IRFEITL, *supra* note 213, art. 10. Losses incurred may be carried over to the succeeding year as a deduction. Such a carryover may not exceed five years.

Chinese law does not clearly provide that taxes and duties other than income tax are deductible. Article 10 of the IRFEITL, however, specifies nondeduction items as "income tax payment and local income tax payment." Presumably, taxes other than income tax would be deductible. IRFEITL, *supra* note 213, art. 10.

250. IRFEITL, *supra* note 213, art. 11.

251. *Id.* art. 10.

252. The original Chinese text is *Ziben*, which means capital. A translation provided by International Economic Consultants, Inc. turns it into "equity capital." See CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 441. This may carry weight for the proposition in the text.

253. IRFEITL, *supra* note 213, art. 11.

254. *Id.*

255. People's Daily, *supra* note 230.

256. IRFEITL, *supra* note 213, art. 13.

257. For enterprises with an annual total business income of less than 5 million yuan, reasonable entertainment expenses must not exceed 10 percent of the total business income. For those with an annual total business income of more than 5 million yuan, the expenses for that portion above the limit must not exceed 3 percent of the said portion. *Id.*

ible items including expenditures on the purchase or construction of machinery equipment, building facilities, and other fixed assets; expenditures on the purchase of intangible assets; interest on equity capital; income tax payments; penalties for illegal actions; losses already compensated by insurance; donations and contributions other than those for public welfare and relief purposes in China; royalties paid to the head office; and other expenses not relevant to business operations.²⁵⁸ Some of the nondeductible items such as the expenses for fixed assets and intangible property may be indirectly deducted through depreciation.

The FEITL provides for depreciation of fixed assets and amortization of intangible assets. The FEITL defines fixed assets as houses, buildings, machinery and other mechanical apparatus, means of transportation, and other equipment to be used for business operations with a useful life of more than one year.²⁵⁹ Assets with a value of less than 5,000 yuan that have a relatively short useful life may be expensed rather than depreciated.²⁶⁰

The minimum depreciation period varies depending on the nature of the assets. The period for buildings and houses is twenty years; for machinery and other production equipment is ten years; and for other transportation means, business equipment, tools, and furniture is five years.²⁶¹ Foreign enterprises may apply to the local tax bureau for accelerated depreciation. Such an application must be examined by the local tax bureau and submitted for approval, through various tax authorities at different governmental levels, to the Ministry of Finance.²⁶²

Depreciation is based on original cost less residual value and is computed by the straight-line method.²⁶³ The residual value is fixed at 10 percent of the assets.²⁶⁴ The depreciation is calculated on an annual basis, commencing from the month the assets are put into use, and ceasing the next month after the assets are no longer used.²⁶⁵ Assets may not be further depreciated after their original value has been fully depreciated, even though they are still in use.²⁶⁶ The reasonable expenses on intangible assets such as patents, know-how, trademarks, and copyrights may be amortized from the month in which they are put into use.²⁶⁷ The minimum amortization period is usually ten years.²⁶⁸

258. *Id.* art. 10.

259. *Id.* art. 14.

260. *Id.*

261. *Id.* art. 18.

262. *Id.*

263. *Id.* arts. 15 and 17.

264. *Id.* art. 17. Foreign banks may also apply to the tax authority to retain lower or no residual value. *Id.*

265. *Id.* art. 16.

266. *Id.* art. 19.

267. *Id.* art. 21.

b. Payment and Administration of
Foreign Enterprise Income Tax

The foreign enterprise income tax is calculated on an annual basis and paid in quarterly installments.²⁶⁹ Payments are made within fifteen days after the end of each quarter.²⁷⁰ The annual settlement is made within five months after the end of each tax year.²⁷¹ Excess payments are refunded and deficiencies must be paid. Foreign banks or branches must file with the local tax authority a quarterly income tax return for each quarterly payment of income tax.²⁷² They must file annual income tax returns, together with final account reports within four months after the end of each tax year.²⁷³ These income tax returns must normally be accompanied by an audit certificate issued by a public accountant registered in China.²⁷⁴

Foreign banks and branches must also report to the local tax authority their financial management methods and their accounting system for records.²⁷⁵ The language used for accounting must be in Chinese or in both Chinese and a foreign language.²⁷⁶ The payment and calculation of tax must be made in Chinese currency.²⁷⁷ Foreign exchange income must be converted into Chinese currency for tax purposes in accordance with the exchange rate promulgated by the State Administration of Foreign Exchange Control at the date the tax return is executed.²⁷⁸

The Chinese tax authority is empowered to audit the accounts of foreign banks or branches for tax purposes.²⁷⁹ The authority must maintain confidentiality.²⁸⁰ Violation of some technical requirements such as timely filing and appropriate accounting may result in a fine up to 5,000 yuan.²⁸¹ Overdue tax is subject to a daily surcharge of 0.5 percent of the tax due.²⁸²

268. *Id.* For intangible assets which were attached with a fixed period of amortization when they were acquired, such a provided period will be permissible even if it is less than ten years.

269. FEITL, *supra* note 212, art. 7.

270. *Id.*

271. *Id.*

272. *Id.* art. 8.

273. *Id.*

274. IRFEITL, *supra* note 213, art. 36.

275. FEITL, *supra* note 212, art. 9. Accounts need to be kept for at least fifteen years. IRFEITL, *supra* note 213, art. 39.

276. IRFEITL, *supra* note 213, art. 39.

277. *Id.* art. 42.

278. *Id.*

279. FEITL, *supra* note 212, art. 12.

280. IRFEITL, *supra* note 213, art. 41.

281. *Id.* art. 44.

282. FEITL, *supra* note 212, art. 14.

A taxpayer who willfully refuses to pay tax or evades tax will be fined up to five times the amount of the tax due.²⁸³

When a taxpayer disagrees with the decision of the local tax authority, he may apply to the higher tax authority for reconsideration. If he does not accept the ruling of the higher tax authority, he may bring a lawsuit in the local people's court.²⁸⁴

B. CONSOLIDATED INDUSTRIAL AND COMMERCIAL TAX

The Consolidated Industrial and Commercial Tax (CICT) has been imposed since 1958 as a result of a tax reformation which consolidated produce tax, turnover tax, retail tax, and stamp tax.²⁸⁵ The CICT is a turnover tax levied on every stage of production or business operations when goods or services are transferred from one business entity to another.²⁸⁶ The taxpayers include foreign enterprises and joint ventures with business operations in China.²⁸⁷ The tax is levied on the gross amount of proceeds from the sale of goods and services at a rate ranging from 69 percent for cigarettes to 2 percent for gas, depending on the nature of goods or services.²⁸⁸ Since the CICT is imposed on the gross income, taxpayers may be taxed even though they sustain a loss. The law lists 104 categories of products and services and sets up a tax rate for each listed item.²⁸⁹

Foreign banking businesses in China are subject to the CICT with respect to three major business operations. First, ROs of foreign banks are subject to the CICT with respect to commissions and other charges for services performed in China for any foreign enterprises other than their own head offices. This was not clear until May 1985 when the Ministry of Finance promulgated interim regulations which expressly brought ROs of foreign banks under the coverage of the CICT.²⁹⁰ Under the interim

283. *Id.* art. 15.

284. *Id.* art. 16.

285. Consolidated Industrial and Commercial Tax Regulations of the People's Republic of China (CICTL), promulgated by the Standing Committee of the National People's Congress on Sept. 13, 1958, *reprinted in* CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 415-22.

286. Enterprises and retailers need to pay CICT for proceeds received from sales. Importers and purchasers of agricultural products must pay CICT on the purchase prices which they pay. Service industries must pay CICT on the gross business proceeds that they receive. *Id.* arts. 4-9.

287. *Id.* art. 2. Since 1973 the CICT imposed on domestic industry was further consolidated with several other taxes and formed *Gongshang shui* (industrial and commercial tax). Since 1985 the new tax reform replaced the industrial and commercial tax with more specific produce, resource, value-added, and turnover taxes.

288. See the tax table attached to the CICTL, *supra* note 285.

289. *Id.*

290. IRTRO, *supra* note 240.

regulations, the income of an RO that falls into the taxable categories listed in the CICT table will be subject to the CICT. The relevant categories in the CICT tax table include trust agencies, intermediary services, purchasing and marketing agencies, and brokerage houses.²⁹¹ Income from these businesses is taxed at a 7 percent flat rate under the CICT table.²⁹² The interim regulations reduced the tax rate to 5 percent.²⁹³ For ROs in the SEZs, the tax rate is further reduced to 3 percent.²⁹⁴

Second, the gross business income of foreign banks and branches located in China is subject to the CICT. Since foreign banks or branches may be allowed to engage in a variety of banking or banking related businesses in China, the CICT may differ depending on the nature of their services. The highest CICT on services, however, is 7 percent.²⁹⁵ Thus, the CICT on direct foreign banking business may not exceed 7 percent.

In 1984 the State Council issued interim regulations which modified the law regarding the CICT as it was applied to the SEZs. The interim regulations provide that income for insurance and banking businesses in the SEZs are subject to a reduced 3 percent of the CICT.²⁹⁶ In addition, newly established foreign banks or branches may apply to the governments of the SEZs for further reduction or exemption of the CICT. Actually, the government of Xiamen SEZ just granted exemptions for five years from the CICT to all foreign bank branches within its jurisdiction, and Shenzhen SEZ also has similar tax regulations which allow exemptions from the CICT on business income until 1995 for foreign banks and foreign bank branches.²⁹⁷ Since foreign banks and branches are currently allowed to establish and engage in banking business only in the SEZs, 3 percent will be the maximum CICT on direct foreign banking business in China.

Third, ROs of foreign banks located in areas other than the SEZs need to pay, in addition to customs duties, the CICT for importing business machinery, office equipment, and transportation means.²⁹⁸ In the SEZs,

291. See tax table of the CICTL, *supra* note 285.

292. *Id.*

293. IRTRO, *supra* note 240, art. 4.

294. A provision in the Regulations for Coastal Cities, *supra* note 216, allows a 3 percent CICTL rate to the SEZs' enterprises engaged in banking and other services. Chapter 1, paragraph 1, however, defines "SEZs' enterprise" as "Chinese foreign joint venture, Chinese-foreign cooperative enterprises and wholly foreign-owned enterprises that are established in the SEZs." *Id.* Thus, ROs of foreign banks are not covered. At a press conference, however, the head of General Tax Bureau of the Ministry of Finance expressly stated that ROs in the SEZs were considered "foreign enterprises" and could enjoy preferential tax treatment. People's Daily, May 15, 1985. Thus, the 3 percent preferential tax, rather than 5 percent, will be applied.

295. IRTRO, *supra* note 240.

296. Regulations for Coastal Cities, *supra* note 216, ch. 2.

297. Young, 2 *China Update*, Apr. 1986, at 4; see also People's Daily, *supra* note 230.

298. IRTRO, *supra* note 85.

the importation of a reasonable quantity of articles other than cigarettes, liquor, and mineral oil is exempted from the CICT.²⁹⁹ Thus, ROs in the SEZs and foreign banks and branches are not subject to CICT for importing necessary office and business equipment.

C. PERSONAL INCOME TAX

The PRC Personal Income Tax Law (PITL) was enacted on September 10, 1980 at the third session of the fifth National People's Congress.³⁰⁰ In December of the same year, the Ministry of Finance issued the implementing regulations.³⁰¹ The PITL and implementing regulations constitute the basic framework of personal income taxation in PRC.

Chinese personal income tax on salary is on a progressive basis ranging from 5 percent to 45 percent, depending on the amount of income.³⁰² Monthly income below 800 yuan is not taxed.³⁰³ A taxpayer with monthly income above 800 yuan will have an 800 yuan deduction and pay tax only on the amount above 800 yuan.³⁰⁴ Income other than salaries such as interest, royalties, and dividends is subject to tax at a flat rate of 20 percent.³⁰⁵

Chinese personal income tax is levied on the basis of source and residency.³⁰⁶ Personal income originating in China is generally subject to Chinese income tax. Income derived from employment performed in China, whether paid by Chinese or foreign employers, is considered Chinese source income subject to Chinese income tax.³⁰⁷ If, however, a foreign national stays in China for less than ninety days and his income is paid

299. Regulations for Coastal Cities, *supra* note 216, ch. 1, para. 5.

300. Personal Income Tax of the People's Republic of China, (PITL), adopted at the third session of the fifth National People's Congress, promulgated Sept. 10, 1980, *reprinted in* CHINA INVESTMENT GUIDE, 1984/85, *supra* note 4, at 433-34.

301. Implementing Regulations of the Personal Income Tax Law of the People's Republic of China (IRPITL), promulgated by the Ministry of Finance Dec. 14, 1980, *reprinted in* CHINA INVESTMENT GUIDE, 1984/85, *supra* note 4, at 434-37.

302. PITL, *supra* note 300, art. 15. This provision contains a tax table:

Grade	Range of Income	Tax Rate %
1	Monthly income of 800 yuan and less	Exempt
2	That part of monthly income from 801 yuan to 1,500 yuan	5
3	That part of monthly income from 1,501 yuan to 3,000 yuan	10
4	That part of monthly income from 3,001 yuan to 6,000 yuan	20
5	That part of monthly income from 6,001 yuan to 9,000 yuan	30
6	That part of monthly income from 9,001 yuan to 12,000 yuan	40
7	That part of monthly income above 12,000 yuan	45

303. *Id.*

304. *Id.*

305. *Id.* art. 3.

306. *Id.* art. 1.

307. IRPITL, *supra* note 301, art. 5, para. 1.

by a foreign employer abroad, his income will be exempt from Chinese income tax.³⁰⁸ Generally, a foreigner working for an RO or foreign bank or branch in China will be subject to Chinese personal income tax if his presence in China exceeds ninety days.

Chinese income tax is also based on the resident status of taxpayers. A Chinese resident living in China for over one year (regardless of his nationality) will be subject to Chinese income tax with respect to his foreign source income.³⁰⁹ Under article 3 of the implementing regulations, if a foreigner resides in China over one year and less than five years he will be taxed only with respect to the part of his foreign source income that is actually remitted to China from abroad. A circular issued by the Ministry of Finance in 1983 modifies these provisions and grants a complete exemption to their foreign source income whether it is remitted to China and whether the foreign taxpayer resides in China over five years.³¹⁰ This exemption, however, applies to the foreigner whose presence in China is attributable to his employment by a joint venture, cooperative, or foreign enterprise. Thus, the income of a foreign employee of an RO or a foreign bank or branch working in China that is derived from abroad such as interest or dividends paid by foreign banks or companies will generally not be taxed in China. Chinese law also allows taxes levied by foreign governments to be credited against the Chinese income tax on the same foreign source income.³¹¹

D. TAXATION OF JOINT VENTURE BANKS

Joint venture banks in China are subject to a separate joint venture tax law.³¹² The rules with respect to deduction, depreciation, amortization, and administration are substantially similar to those of the FEITL dis-

308. *Id.* An interpretation by the Ministry of Finance in June 1981 provides that a foreigner entering into China with a visa valid for more than ninety days is deemed a resident for more than eighty days, and even though his effective stay in China is less than ninety days, he is subject to Chinese tax from the date when he entered China. Absences from China are taken into account for the ninety-day exemption if the taxpayer returns during the effective period of his visa. *Circular of Ministry of Finance Concerning Several Questions on Personal Income Tax*, June 2, 1981, reprinted in *ZHONGGUO JINGJI NIANJIAN (ALMANAC OF CHINA'S ECONOMY)*, III-57 (1982).

309. *Id.* art. 3.

310. Gelatt & Pomp, *supra* note 233, at 39.

311. IRPITL, *supra* note 301, art. 16.

312. Income Tax Law of the People's Republic of China Concerning Sino-Foreign Joint Ventures [hereinafter Joint Venture Income Tax Law], promulgated Sept. 10, 1980, reprinted in *CHINA INVESTMENT GUIDE* 1984/85, *supra* note 4, at 427-29.

Implementing Regulations of the Income Tax Law of the People's Republic of China Concerning Sino-Foreign Joint Ventures, promulgated by the Ministry of Finance Dec. 14, 1980, reprinted in *CHINA INVESTMENT GUIDE* 1984/85, *supra* note 4, at 429-32.

cussed above. Joint venture tax law differs from the FEITL, however, with respect to tax holidays and effective tax rates.

Joint venture income tax is a 30 percent flat rate on net profits plus a local surtax of 10 percent, bringing the total tax rate to about 33 percent.³¹³ The local government may at its discretion reduce or eliminate the local tax.³¹⁴ Additionally, Chinese law imposes a tax of 10 percent on a foreign participant in a joint venture that remits its share of profits out of China.³¹⁵ In the SEZs where joint venture banks are currently allowed to exist, a preferential 15 percent tax rate is applied instead of the 30 percent and the 10 percent tax on profits remittance by the foreign party is not imposed.³¹⁶

Chinese joint venture tax law grants tax holidays to joint venture banks. As a rule, the newly established joint venture with a period of operation of ten years or more is exempt from Chinese income tax during the first two years after it starts to have profits.³¹⁷ It may be allowed a 50 percent reduction in income tax for the next three years.³¹⁸ The tax holidays are not automatically granted; the joint venture banks must apply to the local tax authority for approval.³¹⁹

E. SINO-U.S. INCOME TAX TREATY AND ITS IMPACT ON CHINESE TAXATION OF FOREIGN BANKING BUSINESS

The Sino-U.S. income tax treaty concluded in March 1984 was ratified by the United States Senate in July 1986.³²⁰ This treaty will play a leading

313. Joint Venture Income Tax Law, *supra* note 312, art. 3.

314. *Id.*

315. *Id.* art. 4.

316. Regulations for Coastal Cities, *supra* note 216, ch. 1, paras. 1 and 3.

317. Joint Venture Income Tax Law, *supra* note 312, art. 5. The law originally provided tax exemption for one year and tax reduction for the next two years. In September 1983 the Standing Committee of the National People's Congress issued an order which replaced the original provisions with the present, more liberal tax treatment. See CHINA INVESTMENT GUIDE, 1984/85, *supra* note 4, at 428-29. Note that such preferential tax treatment is accorded only to the joint venture with a period of operation of ten years or more. *Id.*

318. *Id.*

319. *Id.*

320. Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income [hereinafter Sino-U.S. Tax Treaty], Apr. 30, 1984, reprinted in 1 CCH Tax Treaties 1421-32. The Sino-U.S. Tax Treaty was submitted to the United States Senate for approval on August 10, 1984. See Letter of Transmittal, *id.* at 1433. The Senate Foreign Relations Committee considered the treaty and in December 1985 reported favorably to the Senate floor. See INCOME TAX AGREEMENT (AND PROTOCOL) WITH THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA, REPORT OF THE SENATE FOREIGN RELATIONS COMMITTEE ON TREATY DOC. 98-30, 98TH CONG. 2d SESS. (Dec. 11, 1985). The treaty was ratified by the United States Senate on July 24, 1986. 3 INT'L TRADE REP. 387 (1986).

role in the harmonization and coordination of the two tax jurisdictions. It will certainly have an impact on the tax consequences of United States banking business in China.³²¹ The treaty provisions most relevant to the United States banking business in China are those concerning taxation of interest and tax credits.³²²

1. *Treaty and Chinese Taxation on Interest*

The treaty limits source country taxation on interest paid to residents of other states to a maximum of 10 percent.³²³ This rule will not apply if the owner of the interest has a permanent establishment or fixed base in the source country and the debt claim from which the interest arises is effectively connected with the permanent establishment or fixed base.³²⁴ Applying this rule, the interest arising from direct lending to China by American banks would be able to benefit from the treaty's 10 percent tax treatment. Since the effective Chinese tax on interest paid to foreign banks is in most situations no more than 10 percent as discussed above, the treaty would have little impact on the tax status of United States banks in respect to their lending to Chinese entities.

American banks with ROs in China would probably enjoy the same treaty benefits as those without in respect to Chinese taxations on interest. Although these banks have permanent establishments in China, the debt claim from which the interest arises is usually not effectively connected to their ROs, which serve mere liaison functions.³²⁵ Current Chinese tax law imposes a progress tax on net profits from interest income received by foreign banks with ROs in China when the ROs actively participated in the negotiations and conclusions of the loan agreements.³²⁶ This results

321. The treaty will be effective as respects income derived during taxable years beginning on or after the first day of January next following the date on which this agreement enters into force. Sino-U.S. Income Tax Treaty, *supra* note 320, art. 27. Since banking business, especially branching or setting up subsidiaries, must be planned on a long term basis, it is appropriate to take into account at this moment the tax consequences resulting from implementation of the tax treaty.

322. The treaty also has impact on other tax aspects of United States banking business in China. For instance, under the treaty, a United States resident working in China for fewer than 184 days and paid by a United States employer will not be subject to Chinese personal income tax if the compensation is not born by the permanent establishment of the employer in China. Sino-U.S. Tax Treaty, *supra* note 320, art. 14. This will modify the current Chinese tax rule that a United States resident working in China under the situation described above will be subject to Chinese income tax if he remains in China for over ninety days. See IRPITL, *supra* note 301, art. 5.

323. Sino-U.S. Tax Treaty, *supra* note 320, art. 10.

324. *Id.*

325. The ROs usually do not have independent funds as resources to make direct lendings. Loans arranged for by the ROs are generally financed by the head office. The debt claim for which the interest is paid is probably not effectively connected with the ROs.

326. See *supra* text accompanying notes 234-38.

in an effective tax rate lower than the treaty's 10 percent rate on the gross interest income. This rate serves more to attract foreign investments than to deny American banks treaty benefit.

The interest income received by American banks or branches located in China for their lendings to Chinese entities and other business income is considered business profits and subjected to Chinese tax under article 7 of the treaty.³²⁷ Article 7 embodies the rule that business profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business.³²⁸ Since the Chinese tax rule in this aspect is consistent with the treaty, the treaty provisions would have little impact on the tax consequence of foreign banks and branches.

2. Tax Credit

The current United States tax law allows United States residents to credit certain Chinese taxes they paid against their United States tax obligations. The Internal Revenue Service (IRS) has ruled favorably on the creditability of the individual income tax, the income tax concerning foreign enterprises, and local income tax.³²⁹ The IRS has not ruled on the creditability of the income tax on joint ventures. Consequently, the practical impact of the tax treaty on American banking businesses in China primarily extends to the Chinese tax on joint venture banks. Under the tax treaty, the United States will allow a deemed paid credit to a United States corporate shareholder of a Chinese company receiving a dividend from the Chinese company if the United States corporate shareholder owns 10 percent or more of the voting rights in the Chinese company.³³⁰ This credit will be allowed for the income tax paid to China, by or on behalf of the distributing Chinese company, on the profits out of which the dividends are paid.³³¹ Thus, the treaty will supplement the current United States tax law and ensure the creditability of the Chinese joint venture tax on joint venture banks.

VI. Foreign Banking in the PRC: Future Perspectives

The growth of foreign banking in the PRC has its root in the current liberal economic policy. Since 1979 the new policy has substantially im-

327. Sino-U.S. Tax Treaty, *supra* note 320, art. 7.

328. *Id.*

329. Murphy, *U.S. Allows Chinese Income Taxes to be Credited Against United States Income Taxes*, E. ASIAN EXEC. REP., Aug. 1982, at 23.

330. Sino-U.S. Tax Treaty, *supra* note 320, art. 22.

331. *Id.*

proved the environment in which foreign banks operate in China and has created economic justification for foreign banking business to grow. At the domestic level, the new policy has injected tremendous market force into the Chinese economy, and the readjustment has reestablished and strengthened social respect for competition and profit. This policy shift has made it easier for free enterprise type foreign businesses, including foreign banks, to board on Chinese economy and be received with due respect. It has also caused foreign banks to be welcomed with enthusiasm resulting from expectations that their entrance will enhance competition and stimulate efficiency and development in existing Chinese banking business.

The ongoing economic readjustments aiming at ambitious economic expansion have also created tremendous need for capital and funds. Chinese officials have estimated that the total borrowing of foreign funds for the next five years will be \$40 billion.³³² A Journal of Commerce report forecast that about 60 percent of the funds will be in commercial loans.³³³ The presence of foreign banks will help alleviate capital and funds shortage and stimulate economic growth. Moreover, the increasing demand for foreign capital and technology to fulfill the goal of economic modernization will necessarily accelerate the inflow of foreign technology and investment, further expanding Chinese international commercial interrelations with foreign nations. This, in turn, will expand Chinese international financial markets for foreign banks.

Finally, since the open-door policy was instituted, Chinese banks have aggressively sought overseas business opportunities and have rapidly expanded their foreign business operations. For instance, up to the end of 1984 the Bank of China had 261 branches in Hong Kong and Macao,

332. LeBourgeois & Chung, *supra* note 1, at 25. Until recently, China has relied mainly on loans from World Bank and other international organizations and soft loans from foreign governments. Recently, however, China has been looking more to bond issues and commercial loans. Many foreign bankers anticipate that China's use of commercial loans will substantially increase in the coming several years. See *China Gaining Sophistication in International Finance*, Asian Wall St. J. Weekly, Apr. 2, 1986, at 10.

333. *China May Borrow More*, J. Commerce, Nov. 3, 1986, at 3a. The relevant part of the report reads:

China will at last become a significant commercial borrower in the next five years, United States banks attending a symposium on financial markets believe.

"China will be in a position to absorb U.S. \$40 billion worth of capital from world markets in the next five years," said Alan Fishman, senior executive vice president of Chemical Bank.

Diplomatic sources estimate China's borrowing will increase to U.S. \$10 billion a year in the next five years, contrasted with last year's U.S. \$7 billion.

About U.S. \$2.5 billion will be concessional loans from the World Bank or similar agencies, U.S. \$1.5 billion from direct investment and the rest in commercial loans, they forecast.

fourteen other branches in Singapore, Britain, Luxembourg, and the United States, and representative offices in Tokyo and Paris. It also had representative business with 3,151 banks in 149 countries and regions.³³⁴ Other Chinese financial institutions also commenced international expansion.³³⁵ Since foreign banking policy in many countries is based on reciprocity, China's liberal foreign banking policy will eliminate or diminish obstacles to the expansion of Chinese banks' international operations.

The progress of Chinese foreign banking policy over the last several years, from allowing foreign banks to set up ROs to permitting foreign banks to engage in limited direct banking business in some geographic areas demonstrates a pattern of continuing liberalization. This pattern will likely continue with comparable speed and intensity in the coming years.

334. CHINA INVESTMENT GUIDE 1984/85, *supra* note 4, at 29.

335. CITIC has ROs in the United States, Japan, and France. *Id.* at 250. Shanghai Investment and Trust Company recently opened an RO in San Francisco. *See* 2 San Francisco Chamber of Commerce News, Apr. 15, 1986 (Beijing International Investment and Trust Company established jointly with an American businessman, a "BITIC of California" in Oakland, California).

Banking System of the People's Republic of China



