China's new Foreign Investment Law: the impact on financial institutions

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The impact of the foreign investment law on financial institutions

Introduction and overview

Much has already been written about the *Foreign Investment Law* (the "**FIL**", full text in Chinese here, in-house English translation available upon request) which was voted into law by China's highest legislative body, the National People's Congress ("**NPC**") of the People's Republic of China[1] ("**China**" or "**PRC**") on March 15, 2019. The FIL will take effect from January 1, 2020, and the existing legislation that has formed the backbone of Foreign Direct Investment ("**FDI**") regulation in China since the 1980s (currently scattered over three laws[2]) will be repealed on the same day. This note will focus on the impact of the FIL on foreign-funded financial institutions ("**FFFIs**") and related developments.

Impact of the FIL on FFFIs

The FIL is an attempt by the PRC government to align the corporate governance rules applicable to domestic capital companies on the one hand and foreign invested enterprises ("**FIE**") on the other. As noted in our separate note[3], the most significant impact of the FIL is the shift of corporate governance structures and corporate actions from those set out in the FIE Laws to those provided under the *PRC Company Law* ("**Company Law**") or the *PRC Partnership Law*. The same basic premise applies to financial institutions.

In addition, due to the evolving nature of PRC legislative history, it has long since been a challenge for FFFIs to identify a definitive, comprehensive list of the rules applicable to them (the "**Conclusive List Issue**"); and due to the inconsistency between those applicable rules (i.e. those imposed by their regulators, e.g. the China Banking and Insurance Regulatory Commission ("**CBIRC**")[4] (the "**Industry Rules**")) and those under FIE Laws, it is even more challenging for FFFIs to understand which set of rules would prevail over the other (the "**Inconsistency Issue**"). The introduction of the FIL is an attempt to resolve the Inconsistency Issue (although in our view, it does not really address the Conclusive List Issue).

Alignment of corporate governance

Historically, regulators have stipulated various rules on corporate governance which apply generally to the sector, but FFFIs are carved out. FIE Laws also contain corporate governance provisions applicable to FIEs. For example, the *China Insurance Regulatory Commission Opinions on Regulating the Articles of Association of Insurance Companies*[5] requires the shareholder(s) meeting to be the supreme governance body, and prohibits insurance companies from allowing the shareholder(s) meeting to delegate its legal powers to the board of directors ("**Board**"), or any other organization or individual in its Articles of Association. But in its final clause, it states "these opinions are applicable to insurance companies and insurance asset management companies lawfully established within China. In the event that the laws and administrative regulations have separate provisions on foreign-funded insurance companies, the

[1] In this note, references to China exclude the Hong Kong Special Administrative Region, the Macau Special Administrative Region and Taiwan.

[2] The *PRC Sino-Foreign Equity Joint Venture Law* ("**EJV Law**"), the *PRC Wholly Foreign-Owned Enterprise Law* ("**WFOE Law**"), and the *PRC Sino-Foreign Cooperative Joint Venture Law* ("**CJV Law**"),(together the "**FIE Laws**").

[3] The note covering the corporate law implications of the FIL can be viewed here.

[4] The CBIRC is the main regulatory body in charge of banking and insurance industry. It was created by the merger of the CIRC and the China Banking Regulatory Commission ("**CBRC**") in April 2018.

[5] Promulgated by the CIRC, effective 1 October 2008.

provisions of such laws and administrative regulations shall be applicable." In other words, there is a carve-out for legislation regulating FFFIs. Under the FIE Laws, foreign funded insurance companies ("**FFICs**") in the form of EJVs or cooperative joint ventures ("**CJVs**") still have the Board as their supreme governance body and thus do not need to follow the regulator's requirements in terms of corporate governance.

The FIL requires governance structures of entities formed under the FIE Laws to align with those under the Company Law to be consistent with those of their domestic capital counterparts over a five year period counting from the effective date of the FIL[6], so now FFFIs will need to consider whether to shift over to those corporate governance-related regulatory requirements when they next seek to amend their Articles of Association and Joint Venture Contracts/Shareholders Agreements.

Inconsistency issue

With the introduction of Article 41[7] on the FIL, and based on Article 218 of the Company Law[8], it is now clear that in case of inconsistency, industry rules applicable to FFFIs will prevail over the FIL, and the forthcoming implementing rules for the FIL and other rules applicable to FIEs [9] will continue to prevail over inconsistent provisions of the Company Law.

In reality, taking FFICs as an example, after the FIL comes into force, given that the *Foreign-funded Insurance Company Administrative Regulations*[10] ("**FFIC Regulations**") and the *Foreign-funded Insurance Company Administrative Regulations Implementing Regulations*[11] ("**FFIC Implementing Regulations**") are basically silent on the issue of corporate governance, so in that case, presumably, the corporate governance provisions in the Company Law would apply to FFICs. However, the minimum registered capitalisation provisions set out in Article 7 of the FFIC Implementing Regulations which provide that equity joint venture ("**EJVs**") and wholly foreign-owned enterprise ("**WFOE**") insurance companies need to have a minimum registered capital of RMB 200 million (fully paid up in cash) would still apply. Furthermore, in the same way the sector-specific application procedures, including the two-step establishment process (which is common to both domestic capital and FFFIs) and the capitalisation and qualification requirements applicable to most FFFIs (which tend to be FFFI-specific), including FFICs would presumably still apply after the FIL comes into force. To the extent China has not applied national treatment to the sector e.g. life insurance, where under the current 2018 *Special Administrative Measures on the Access of Foreign Investment to China* ("**Negative List**") only a 51% foreign shareholding is permitted pending full liberalisation in 2021, then additional qualification and procedural requirements may apply to foreign investors. Arguably once you have full 'national treatment' then query whether China still has the right to impose any additional procedural or qualification requirements for establishment that are not imposed on domestic capital counterpart applicants.

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6 Article 42 of the FIL.

7 Article 41 of the FIL provides that "where the State stipulates otherwise with respect to the administration of foreign investors investing in the banking, securities, insurance and other such financial sector industries in the PRC, or in PRC securities markets, foreign exchange markets and other financial markets, such provisions shall apply".

8 Article 218 of the Company Law provides that "This law shall apply to limited liability companies and joint stock limited liability companies with foreign investment, but where the laws relating to foreign investment make other provisions, such other provisions shall be applied".

9 Strictly speaking, Article 218 of the Company Law only carves out provisions in "laws" (法律), i.e. the FIL, however, in the past, the PRC Ministry of Commerce ("**MOFCOM**") tended to give this an expanded interpretation to also include administrative regulations and departmental rules.

10 Promulgated by the State Council on, and effective on 6 February 2016.

11 Promulgated by the then CIRC on, and effective on 13 February 2018.

Conclusive List Issue

While the introduction of the FIL is a worthy attempt at streamlining the rules applicable to FIEs (including FFFIs), the legal regime applicable FFFIs is still far from being comprehensive, cohesive or anywhere near systematic.

(a) Conflicting regulatory treatment within the sector: DFFIs V FFFIs

Regulation in relation to many aspects including market entry, commencement of business inspection and management also differ between FFICs and domestically-funded insurance companies ("**DFICs**") on the on hand, as well as between foreign-funded banks ("**FFBs**") and domestically-funded banks ("**DFBs**") on the other. For instance, the *Equity Interests in Insurance Companies Administrative Measures* ("**Insurance Equity Interests Measures**")[12] mainly applies to DFICs, and only applies "by reference" (which means the legal document is not strictly binding on such entities and can be deviated from as necessary) to FFICs in which foreign shareholders hold more than 25% of the equity interests. FFICs mainly apply the FFIC Regulations and FFIC Implementing Regulations when it comes to changes in equity interests. In the recent change of shareholder in Huatai Insurance Group, where Chubb Bermuda Insurance Ltd. acquired 1.2433% of the equity interests of Huatai Insurance Group, thereby increasing its shareholding to 26.1772% and exceeding the 25% threshold and transforming Huatai Insurance Group from a domestic-funded insurance company into a foreign-funded insurance company, the CBIRC approved this equity change based on the FFIC Regulations and the FFIC Implementing Regulations, not under the Insurance Equity Interests Measures. This demonstrates how even CBIRC itself seems to apply the rules inconsistently, as technically, the starting point here was a DFIC.

(b) Conflicting regulatory treatment: Finance sector v FIEs

Currently, the regulatory distinction between FFFIs and domestically-funded financial institutions ("**DFFIs**") is inconsistent with the way other types of FIE are regulated under the FIE Laws[13]. Under relevant laws, regulations and other rules, PRC-incorporated insurance companies have traditionally been divided into FFICs and DFICs based on the threshold of having a 25% foreign shareholding. Although the latest *Insurance Companies Administrative Provisions*[14] no longer distinguish between DFICs and FFICs, regulatory practice and other relevant rules still apply such distinction. Similarly, PRC-incorporated banks are divided by regulatory bodies into FFBs and DFBs, based on the status the bank obtained *on establishment*. In other words, if a foreign investor buys into an established DFB as a promoter or strategic investor, the bank would maintain its original status as a DFB in respect of its supervision and regulation by the regulator.[15] This is in contrast to the position under the FIE Laws[16], where as long as there is a foreign shareholder in an FIE[17],

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12 Promulgated by the then CIRC, effective 10 April 2018.
13 See footnote 2 for definition.
14 Promulgated by the then China Insurance Regulatory Commission ("**CIRC**"), effective 19 October 2015.
15 See Article 11 of *Administrative Licensing Matters relating to Chinese-funded Commercial Banks Implementing Measures*, effective 17 August 2018.
16 The EJV Law refers (at Article 4) to the concept that the proportion of the registered capital of an equity joint venture invested by foreign parties should not *generally* fall below 25%.
17 There are some specific legal provisions that only apply to FIEs where the proportion of foreign investment is below 25%.

regardless of its shareholding proportion, such an enterprise will, for all intents and purposes, be regulated as an FIE.

This leaves us with a messy patchwork of laws applying to financial sector FIEs. Despite the fact that the FIL has dropped the in principle 25% foreign investment threshold for identifying FIEs, and adopts a more expansive definition of foreign investment going beyond mere equity investment, it is not clear that the FIL will change this hybrid "mix and match" regulatory approach. Going forward under the FIL, there will no longer be any in principle *de minimis* threshold in terms of extent of foreign investment before you become regulated under the FIL, which further undermines the argument for maintaining the FFIC v DFIC distinction based on foreign investment percentage. Presumably the issue will resolve itself gradually over time, as you should be able to have one set of rules applicable to all DFFIs and FFFIs once you have 'across the board' national treatment.

Related developments - Leveling the playing field

Articles 3, 9, and 16 of the FIL, among other things, place greater emphasis on fair competition and equal treatment between foreign investors and Chinese domestic capital investors. This is consistent with the declared policy of the Chinese government to further open up the financial sector. The financial services sector used to be one of the most heavily restricted to foreign investment. Foreign investors have struggled to gain traction in many parts of it e.g. in banking, partly due to the huge networks built up by the Chinese banks, but also due to competition from more nimble payment and FinTech companies. However over the past two years, a number of concrete opening up measures have been announced, most of which have been put into effect, including relaxing restrictions relating to shareholding percentages, administrative licenses required for market entry, business scope and business qualifications for participation in the financial markets.

In addition to those liberalisation measures set out in the Negative List (foreign investment in securities companies, securities investment fund management companies, futures companies and life insurance companies increased to a maximum of 51% with all shareholding restrictions to be lifted in 2021), twelve further opening measures to be implemented in the near future were recently announced by the Chairman of the CBIRC on 1 May 2019:

1) Remove the upper limit for the shareholding proportion in DFBs applicable to both any single DFB or single overseas financial institution ("**OFI**"), in accordance with the principle of national treatment of foreign and domestic investors ("**National Treatment**").

   This seems to be a reiteration of a measure already put forward last year. Previously, under the *Equity Investment by Overseas Financial Institutions in Chinese-Funded Financial Institutions Administrative Measures* ("**Overseas Equity Investment Measures**"),[18] equity investments made by a single OFI could not exceed 20% of the total and the aggregate equity investments made by all OFIs could not exceed 25% of the equity interests or shares in any given DFB. Similar provisions can also be found in the now largely superseded 2017 version of the *Guidance Catalogue for Foreign Investment Industries*[19].

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[18] Issued by the then CBRC, repealed on August 17, 2018.

[19] Issued by the National Development and Reform Commission ("**NDRC**") and MOFCOM, effective July 28 2017. The negative list it contains has been replaced by the (2018) Negative List, but the 'encouraged' category section remains in force.

In 2018, these restrictions were first removed from the (2018) Negative List, and then the CBIRC completely repealed the Overseas Equity Investment Measures, clearing the way for OFIs to invest in DFBs free from shareholding ratio restrictions.

That said, a spokesman for the CBIRC indicated that,[20] as a practical matter, last year's measures only allowed foreign investors to invest in large banks[21] and financial asset management companies without any upper limit on their shareholding, but this year's repeal of the Overseas Equity Investment Measures will, in addition, allow foreign investors to invest in small and medium-sized commercial banks, including joint-stock banks and city commercial banks.

2) Remove the USD10 billion total asset requirement for a foreign bank to establish a FFB and the USD20 billion total asset requirement for a foreign bank to establish an overseas bank branch in China. Previously, under the *Foreign-funded Banks Administrative Regulations* ("**FFB Regulations**"),[22] if a OFI wanted to establish a WFOE FFB or a Joint Venture ("**JV**") FFB in the PRC, the sole or main foreign investor had to be a commercial bank with no less than USD 10 billion in assets. If a foreign commercial bank wanted to establish a branch in the PRC, the foreign commercial bank had to have no less than USD 20 billion in assets. With the removal of such restrictions as announced by the CBIRC, foreign investors will no longer have to meet any asset qualifications at all, and will only need to meet prudential requirements[23] similar to their domestic counterparts.

3) Remove the USD1 billion total asset requirement for an OFI to buy equity interests in a trust company;

4) Allow other types of overseas non-insurance financial institutions to buy equity interests in FFICs established in the PRC.

Previously, the foreign shareholder(s) of FFICs had to be insurance companies. Now, non-insurance companies will also be allowed to hold equity interests or shares in FFICs. However, the main shareholder in any FFIC must still be an insurance company.

5) Remove the 30 year operating track record and total assets of no less than USD200 million requirements for a foreign insurance brokerage company to operate insurance brokerage business in the PRC.

Previously, under the FFIC Regulations, in order to establish a foreign-funded insurance brokerage company in which foreign shareholders held more than 25% of the equity

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20 See new report https://baijiahao.baidu.com/s?id=1632385502954404288&wfr=spider&for=pc

21 Based on the latest (2019) official list of banking institutions, the Industrial & Commercial Bank of China, the China Construction Bank, the Bank of China, the Agricultural Bank of China and the Bank of Communications are regarded as the five large state-owned commercial banks.

22 Issued by the State Council, effective January 1, 2015.

23 See FFB Regulations Article 9: "A shareholder that proposes to establish a WFOE Bank or JV Bank or the foreign bank that proposes to establish a branch or representative office must meet the following conditions: (1) It has sustained profitability, good reputation, and no record of major violation of laws and regulations; (2) The shareholder that proposes to establish a WFOE Bank, the foreign shareholder that proposes to establish a JV Bank, or the foreign bank that proposes to establish a branch or representative office has experience in international financial activities; (3) It has an effective anti-money laundering system; (4) The shareholder that proposes to establish a WFOE Bank, the foreign shareholder that proposes to establish a JV Bank, or the foreign bank that proposes to establish a branch or representative office is subject to effective regulation by the financial regulatory authority in the country or region where it is located, and its application has been approved by the said financial regulatory authority; and (5) It meets other prudential requirements as specified by the banking regulatory authority under the State Council. The country or region where the said shareholder or foreign bank is located shall have a sound financial regulatory system, and its financial regulatory authority has already established a good supervision and administration cooperation mechanism with the banking regulatory authority under the State Council."

interests, foreign investors had to meet the following additional requirements which did not apply to their domestic capital counterparts: (1) it must be a foreign insurance company which has more than 30 years of operational experience within a WTO member state; (2) it had established a representative office in the PRC for at least two consecutive years; (3) its total assets at the end of previous year exceeded USD200 million. CBIRC announced the removal of the second requirement last year.[24] Now, the other two requirements will be removed, which means foreign investors will face no additional requirements, only the prudential requirements under the *Insurance Brokerage Regulatory Provisions*[25] which are the same as those applicable to their domestic capital counterparts.

6) Relax the requirement for Chinese shareholders in Sino-foreign JV FFBs, removing the requirement that the only or main Chinese shareholder must be a financial institution;

7) Encourage and support OFIs to carry out all forms of cooperation with private-capital-holding banking and insurance institutions in China, including collaborations based on equity investment, business and technology;

8) Allow overseas insurance group companies to invest in establishing insurance-type institutions.

   Under the *Insurance Group Companies Tentative Administrative Measures* (the "**Insurance Group Companies Measures**"), [26]an insurance group company means a company that exerts control, joint control and material impact on the member subsidiaries of the insurance group, and at least two of such member subsidiaries are insurance companies and the main business of such group should be insurance business. In the PRC, the name of such insurance group company would often contain the word "insurance group" or "insurance holding".

9) Allow foreign-funded insurance group companies within the PRC to act as promoters of, and establish insurance-type institutions by reference to the qualification requirements for domestic-funded insurance group companies under the Insurance Group Company Measures.

10) Relax market access policies for both DFFIs and FFFIs to invest in establishing consumer finance companies based on the principle of National Treatment;

11) Remove approval requirements for FFBs to operate RMB business, and allow FFBs to operate RMB business upon commencement of business;

12) Allow FFBs to operate agency collection and payment business, which means FFBs can also act as agents to receive money on behalf of their customers or to make payments on their behalf, such as payments of insurance premiums, rents and salaries, and collection of dividends, pensions, rents and so forth.

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24 See the CBIRC announcement: http://www.cbrc.gov.cn/chinese/newShouDoc/BEE68B1C27C04D6CBF04233814F9B7C8.html

25 Issued by the then CIRC, effective May 1, 2018. Article 8 The following organisations and individuals must not be shareholders in an insurance brokerage company: (1) an organisation or individual that has been subject to criminal punishment or a major administrative punishment during the past five years; (2) an organisation or individual that is currently being investigated by the relevant authorities for allegedly committing a serious illegal act or crime; (3) an organisation or individual that is identified by the relevant State agency as a joint punishment target due to a serious dishonest act and should be punished accordingly in the insurance sector, or that has other serious bad faith records over the past five years; (4) an organisation or individual which is prohibited by laws and administrative regulations from investing in an enterprise; or (5) any other organisation or individual deemed by the CIRC to be inappropriate to be a shareholder of an insurance brokerage company based on the prudent supervision principle.

26 Issued by the then CIRC, effective March 12, 2010.

The above opening up measures still need to be set out legislation before they can be implemented in practice. At time of writing, the spokesperson of the CBIRC had indicated that two sets of implementing rules for the FFB Regulations and FFIC Regulations will be promulgated in the near future, so while implementation is still a work in progress, the policy direction is clear.

Conclusion

FFFIs are left in a strange place by the FIL. On the one hand they are the one class of institutions the regulation of which is partially carved out of the scope of the FIL, reflecting the historical divide where financial institutions were seen as the one exception to MOFCOM's remit as general foreign investment and FIE regulator, with some financial institutions essentially falling outside of MOFCOM's remit. It is well known that there has historically been an uneasy relationship between MOFCOM and now CBIRC (legacy CBRC) over which body has the right to regulate 'cross-over areas' such as commercial and finance leasing.

On the other hand, this carve-out provision should mean that the rules applicable to FFFIs still apply in the event of a conflict with the FIL, but, to the extent that such FFFI-sector laws are silent on a given issue, the provisions of the FIL (including the reference back to the Company Law as the main source of governance rules) should apply in regulating FFFIs as the fall-back law. In other words, FFFIs will remain an odd hybrid under the new FIL regime, just as they were under the FIE Laws, caught between two regulatory worlds: of FFFI-specific regulation on the one hand and that applicable to all foreign investment projects under the FIL on the other, perhaps a reflection of their unique status and sensitivity.

Absent sector-specific contrary governance requirements, FFICs will, like all other FIEs, have a maximum of 5 years from the effective date of the FIL to shift their structures over to those provided under or referenced under the FIL[27], thus bringing them a step closer to DFFIs in governance terms. The liberalisation measures set out above will also bring true National Treatment a step closer, but given the extent to which DFFIs are entrenched and have established extensive national subsidiary and branch networks, plus fierce competition from online banks and payment companies, it will still be a steep mountain for FFFIs to climb when seeking to compete with these, with product design and better corporate governance likely to be key battlegrounds. With that in mind, it may make sense for FFFIs in China to pre-emptively review their governance provisions in their constitutional documents now to ensure that they are FIL-compliant so that they can march into the post-FIL world with a stable structure that will not need to be changed down the road in place.

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[27] Article 42 of the FIL i.e. those set out in the Company Law.

Contacts

Andrew McGinty
Partner, Hong Kong
andrew.mcginty@hoganlovells.com

Jun Wei
Partner, Beijing
jun.wei@hoganlovells.com

Roy Zou
Partner, Beijing
roy.zou@hoganlovells.com

Shengzhe Wang
Counsel, Shanghai
shengzhe.wang@hoganlovells.com

Shantay Cong
Senior associate, Shanghai
shan.cong@hoganlovells.com

Shirley Guo
Junior associate, Shanghai
shirley.guo@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
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