

Foreign investment in the age of convergence

Jeanette K Chan and Hans-Günther Herrmann of Paul Weiss Rifkind Wharton & Garrison outline how recent regulatory changes affect retail financial services

Until recently, China imposed a strict separation on different types of financial services. Banks and insurance companies were not allowed to invest in each other or be involved in the business reserved to the other. Synergies and cooperation between these different types of services were restricted, because interests could not be aligned through shareholding and voting rights. It was not possible to create a single platform to provide a variety of financial services.

Foreign investors often had to invest separately in a bank, an insurance company, a fund management company and a securities brokerage to provide services to retail customers, and hope that these entities could be coaxed into forming a coherent platform for branding, distribution and back-office support.

For banks and insurance companies, regulators in practice offer a choice between two models. A foreign investor can establish a branch of the foreign corporation or a foreign-invested enterprise (FIE) as a greenfield operation without an existing customer base and distribution network, but with the maximum permitted foreign ownership ratio (see Table). Or the foreign investor could take a minority interest of no more than 20% in an existing *domestic* bank or insurance company. A *domestic* entity differs from an FIE in that it has less than 25% aggregate foreign ownership, it is not subject to restrictions on foreign service providers and is generally able to obtain regulatory approvals, for example, for offering new products and services or opening additional branches, more easily than an FIE. Foreign investments in *domestic* banks and insurance company often reflect the Chinese party's search for a strategic minority investor to prepare for a public listing or improve a stagnant or ailing business. Law does not prohibit a *domestic* bank or insurance company from being converted into an FIE through an initial or follow-on acquisition, but this has not occurred so far.

This legal framework has led many foreign investors to invest in several companies in various locations, with different partners and different ownership percentages, making their China strategy unsatisfactory.

Recent concerted action by China's financial services regulators has softened the separation between various financial services, and also impacts other aspects of management and operations in the industry. Foreign investors can take advantage of these changes.

Regulatory action for convergence

For several years, China's three financial services regulators, the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission (CIRC) and the China Securities Regulatory Commission (CSRC) consulted widely with their overseas peers, but took little action. Convergence occurred to some extent through investments by pure holding companies (which were not subject to regulatory supervision under Chinese law) or overseas affiliates of Chinese companies (which are outside Chinese regulators' jurisdiction) making equity investment across financial services.

This year, the regulators sprang into action. In April, CBRC and CIRC held a widely publicized meeting and concluded an (as yet unpublished) agreement that should open the way for cross-shareholding between banks and insurance companies. CBRC and CIRC agreed on a compromise regarding sharing regulatory responsibilities:

CBRC would supervise groups in which the banking activity dominated, whereas CIRC would be responsible for supervising insurance-dominated groups. CIRC has clarified its regulatory role in a circular issued in July 2006: it will seek to supervise insurance companies and insurance holding

companies (that is, companies that do not themselves hold insurance operating permits and so do not fall under CIRC's day-to-day supervision) in their investments in banks, securities companies, trust companies and other non-insurance entities. The CIRC-regulated insurance and insurance holding companies will have to report financial information and major developments of these entities to CIRC, so that CIRC can step in if the insurance companies' solvency or operations are affected.

In June 2006, the State Council, the highest body of the Chinese government, issued the lengthy "Several Opinions on the Reform and Development of the Insurance Industry". Among wide-ranging policy statements, which emphasize the importance of insurance for economic development and social stability, the

State Council stated that it would support insurance companies' investment in banks, but mentioned only premium income investment for this purpose.

These high-level policy initiatives will be translated into specific regulations in due course. According to the regulators' usual practice, trials by a few large state-controlled corporations will probably be conducted before all operators can benefit from the announced changes. Meanwhile, the regulatory landscape for various retail services has already changed and allows existing companies or groups of companies to expand the services they provide.

Banks' fee-based retail services

Industry observers expect fee-based services to contribute an increasing portion of Chinese banks' profits, as lending margins decline through the liberalization of interest rates on loans and deposits. Subject to CBRC approval, commercial banks may conduct various intermediary services, including insurance agency, securities brokerage and asset management services.

But there are practical limits on the remuneration of these services. For an insurance company, in any year, agency commissions are deductible as expenses only up to 8% of aggregate premium revenue received during the same year. Payments by an insurer to a bank distributor other than commissions are not permitted. In a June 2006 notice, CBRC reiterated this existing prohibition, and elaborated that, other than commissions stipulated in a cooperation agreement between bank and insurer, no remuneration or incentive

may be paid in any form to the bank distributor, its sales outlets, managers or employees. This rule is intended to prevent kickbacks, but it might also restrict incentive structures that are legitimate and necessary to ensure branch managers and sales staff effectively implement the bank's distribution

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objectives.

Other provisions of the June 2006 notice show that CBRC wants to encourage the development of new distribution methods and development of targeted products through cooperation between banks and insurance companies, while ensuring fair information for consumers.

Management of retail assets

Banks distribute fund products of affiliated or third party providers. Intense competition has developed among Chinese fund management companies, some of which have sought foreign investment, while others prefer to remain independent. Foreign investors are constrained by foreign ownership limitations. Initially, after China's accession to the World Trade

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Organization in December 2001, foreign investors could only acquire a 33% interest in a Chinese fund management company. Since December 2004, this limit has been increased to 49%, but some of the early foreign investors have not yet increased their shareholding accordingly.

Other limitations on foreign investment are more insidious. In practice, CSRC permits foreign financial services groups to invest only in a single fund management company, whereas domestic investors may hold a controlling interest in one fund management company and a minority interest in another. As foreign investors establish a market presence by investing in various financial service providers, this restriction can have severe consequences. A foreign bank that has established a fund management joint venture with one Chinese bank will not be able to establish a second joint venture with another bank or securities company and so will find it more difficult to develop strategic relationships with several Chinese institutions.

Through a circular issued in May 2006, CSRC has added further restrictions to enforce stability and prevent changing alliances in the fund management industry. Under previous rules, all shareholders of fund management companies were locked up for one year from the date of their investment before they could transfer their interest. Now, in addition, if an investor transfers its interest within less than

three years after it made the acquisition, CSRC considers this investor to have definitively exited the market: the May 2006 circular states that CSRC will not consider any new application from any investor which sold its interest in a fund management company during this three-year period to establish, or acquire an interest in, any fund management company. This restriction will force foreign investors to consider their choice of Chinese joint venture partner even more carefully than before as they are practically required to hold their interest for at least three years: thorough due diligence is necessary to flush out problems in an industry plagued by financial instability and corporate governance issues.

Competition in this market will further increase when insurance asset management companies will be permitted to provide fund management services. Insurance asset management companies may only manage insurance and corporate annuities assets, but CIRC has reportedly drafted regulations that will allow these companies to also conduct fund management business themselves or through subsidiaries. Trials to enlarge the business scope of insurance asset management companies are already under way in selected large insurance corporations. While foreign investment in insurance asset management companies is permitted, the foreign ownership ratio is limited to 25%, compared with 49% in fund management companies.

Issues for foreign investors

As the Chinese financial services regulators break down barriers, more distribution channels become available and more entities with backgrounds in the banking, insurance or securities business will compete with each other. FIEs and branches of foreign corporations do not have a retail network suitable for this competition, so they participate through fund management joint ventures, and *domestic* banks and insurance companies in which they hold a minority interest. In these companies, foreign investors aim to maximize their influence as a minority shareholder and benefit from the opportunities offered by convergence.

Negotiating distribution and cooperation arrangements

Investing in a Chinese financial services corporation does not mean that access to a distribution and services platform is guaranteed. A foreign investor who wishes to implement bancassurance or fund distribution practices that have been successful in other continents will meet many obstacles. Separate subsidiaries might be run completely independently from each other without common objectives or services. Intragroup services might be provided at less than market rates, so that some group members are subsidized by others. Special terms and attention might be granted by the parent company to a group member that is publicly listed or preparing for listing. These arrangements could be to the detriment of the entity in which a foreign investor holds or acquires shares.

Also, in Chinese banks, provincial branches enjoy a strong degree of autonomy; cooperation agreements executed by the head office may not be implemented until specific implementation agreements and an incentive structure have been agreed at branch level. As shown above, CBRC and CIRC regulations constrain these negotiations for bancassurance distribution.

These issues, their impact on the financial model of a proposed investment and possible solutions have to be addressed early on, in the investment process as part of the due diligence, business and term sheet discussions. At a later stage, it is difficult to overcome policies and ingrained habits within a group. Investors can of course hope that a more efficient services structure will emerge as competitive pressure increases, but the timing of change is not certain, and they might not benefit any or all of the foreign shareholders in various members of a financial services group.

Influence on management

The corporate governance arrangements of a Chinese company are set out in its articles of association, which must be approved by the relevant financial services regulator and, in case of FIEs that are not banks or insurance companies, the Ministry of Commerce. Foreign investors should require that their corporate governance rights, such as regarding nomination of directors and officers, and supermajority decisions, are stipulated in the articles of

Table 1: China's commitments regarding foreign ownership in financial services under the General Agreement on Trade in Services

Sector	Sub-sector	% of foreign ownership permitted
All insurance and insurance-related services	• Life, health and pension/annuities insurance	For non-life insurers, 51% upon accession, 100% within two years after accession
	• Non-life insurance	
	• Reinsurance	For life insurers, 50% upon accession
	• Services auxiliary to insurance	For reinsurance and other services, 50% upon accession, 51% within three years after accession, 100% within five years after accession
Banking services	<ul style="list-style-type: none"> • Acceptance of deposits and other repayable funds from the public • Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction • Financial leasing • All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts (including import and export settlement) • Guarantees and commitments • Trading for own account or for account of customers: foreign exchange 	100% for foreign-invested bank
Motor vehicle financing by non-bank financial institutions		100%
Other financial services	<ul style="list-style-type: none"> • Provision and transfer of financial information, and financial data processing and related software by supplier of other financial services • Advisory, intermediation and other auxiliary financial services on all activities of banking services and other financial services mentioned above, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy 	100%
Securities		33% upon accession, 49% within three years after accession

association, and not in shareholders' agreements, whose enforceability is untested in China.

In companies limited by shares (the prevailing company form for *domestic* financial institutions), a limited number of issues must be decided by the shareholders. The board of directors is the most important body for supervising day-to-day management, which is headed by a general manager or president who is comparable to a CEO. There is also a supervisory board with limited control rights, but no decision-making powers.

For companies limited by shares, Chinese law does not prescribe that any of these officers must be appointed with reference to the investors' *pro rata* shareholding. Absent specific provisions in the articles of association, a minority shareholder can be completely excluded from the board of directors, which, among other decisions, appoints the executives. So board nomination rights need to be stipulated in the articles of association.

In Chinese-foreign equity joint ventures (the most common form of FIE in financial services industries), there is no shareholders' meeting, and directors must be appointed *with reference* to the investors' shareholding ratio. Again, nomination rights should be specifically

provided in the constitutional documents of the FIE (joint venture contract and articles of association).

In practice, CBRC and CIRC do allow a foreign investor in a *domestic* entity to nominate more directors than the number that corresponds to their strict *pro rata* shareholding, but would not accept a foreign-controlled board. However, foreign shareholders also benefit from new rules on independent directors, which dilute the influence of majority shareholders. For banks organized as companies limited by shares, CBRC requires that the number of independent directors must be enough to ensure the independence of the board. In banks with a registered capital of Rmb1 billion (\$125 million) or more, there must be at least three independent directors. Starting in 2006, insurance companies must have initially two independent directors, and eventually (no time limit is set) one-third of all directors must be independent. This requirement is set out in detailed opinions on corporate governance of insurance companies limited by shares, issued by CIRC in January 2006. These rules are also applicable *by reference* to insurance companies that are established under other company forms (so, in principle, also FIEs) and insurance asset management companies.

Below the board level, both CIRC's January 2006 opinions and corporate governance guidelines for banks issued by CBRC in April 2006 require the establishment of certain committees with defined reporting obligations. Foreign investors should ensure that they are represented on these committees and might benefit from the devolution of certain responsibilities to these committees to increase their influence over corporate decisions. In addition, formal or informal committees may be established to oversee certain aspects of operations that are of particular interest to the foreign investor.

While CBRC and CIRC focus on the board of directors and its fiduciary duties and wish to limit the possibility and effects of board control by individual (in particular foreign) shareholders, there is more flexibility at management level. In this area, foreign investors can negotiate for the right to nominate certain officers.

As the opportunities in China's financial service markets increase, it will become even more important that foreign investors structure their investments by taking into account this changing regulatory framework and corporate governance requirements.-