Financial Services Liberalisation in the China (Shanghai) Pilot Free Trade Zone: Reflections on Regulations and Regulators

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Abstract: With the foundation of China (Shanghai) Free Trade Zone, China's reform also enters a new stage. Under the era of global financial crisis, strong and efficient financial services supervision is in urgent need. Through analyzing the supervision situation in Shanghai FTZ, also the global financial supervision model reform since financial crisis, financial regulation in Shanghai free trade zone should be based on protecting the interests of the investors and the public. Supervision should consider the balance of cost and effect, and its target should not be too complicated. Then the following recommendations are concluded: ① Financial regulatory legislation system in Shanghai FTZ should be improved, also macro-prudential regulation should be strengthened. ②Offshore financial business regulation in Shanghai FTZ should be improved; ③ In ShanghaiFTZ, measures should be taken to improve interest rate marketizationsupervision; ④ Regulation to capital account open should be improved.

Keywords: China (Shanghai) Pilot Free Trade Zone, Financial Supervision, Policy Suggestion

1. Introduction

The reform process of the financial sector started with the decision of the 16th Chinese Communist Party National Meeting in 2002, where the direction was given to start the process and to allow privately owned business to become part of the financial sector, this included allowing foreign-owned companies into the sector, albeit gingerly as minority shareholders in existing (state-owned) banks.[2] It has been a process of steady but cautious reform to reposition the Chinese financial sector into a more

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[2] Insert reference

market-oriented logic and revise the role of the state of the regulator and the facilitator of this process.[3]

The second major push in the reform process has followed about a decade later. On 17 August 2013, the establishment of the China (Shanghai) Pilot Free Trade Zone (CSPFTZ) was approved by the State Council.[4] This second push aims to internationalise the Chinese financial sector, position Shanghai as a first tier international financial centre and to lay the foundations for the internationalisation of the renminbi and the eventual acceptance of the Chinese currency as a reserve currency.

The CSPFTZ was inaugurated on 29 September 2013.[5] The CSPFTZ has jurisdiction over four customs zones: the Waigaoquiao Free Trade Zone, the Waigaoquiao Bonded Logistics Park, Yangshan Free Trade Port Area, and the Pudong Airport Free Trade Zone.[6] The creation of the CSPFTZ has united these four customs zones that previously operated as separate bonded areas into a single free trade zone. This process started in 1990 when bonded areas were created and when Shanghai was also chosen as the location to pilot this system with the inauguration of the Waigaoquiao Free Trade Zone in 1990. This was followed in 2003 by the Waigaoquiao Bonded Logistics Park. The first free trade port in China was the Yangshan Free Trade Port Area (2005). In 2009 the Pudong Airport Free Trade Zone was decided and the expansion of the zone was realised in 2012. The total area of the CSPFTZ is now 28 square km.[7]

The CSPFTZ is a national project that dovetails with the development plans of the Shanghai Municipal Government. In 2006, the Eleventh Five Year Plan of Shanghai put forward the construction of the “four centres” of Shanghai, that is making Shanghai an international economic centre, an international financial centre, an international trade centre and international centre.[8]. The CSPFTZ is part of the implementation of this “four centres” plan.

While several cities ‘clamoured’ to be chosen for this pilot, the Shanghai Municipal Government prevailed in its bid to host the pilot project.[9] The Shanghai Municipal Government was strongly motivated as it faced rising manufacturing costs that result

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3 See Wei Ping He, Banking regulation in China: what, why, and how?, 20(4) Journal of Financial Regulation and Compliance 367 (2012).

4 Insert reference

5 WTO, Trade Policy Review China – Report by the Secretariat (WT/TPR/S/300) (27 May 2014), at 51.

6 Circular of the State Council on Printing and Distributing the Overall Plan for China (Shanghai) Pilot Free Trade Zone (GuoFa [2013] No.38)

7 Insert reference to official decisions of the state council for all these events.
Also see, WTO, Trade Policy Review China – Report by the Secretariat (WT/TPR/S/300) (27 May 2014), at 51.

8 See for “Outline of the Eleventh Five-Year Plan for National Economic and Social Development in Shanghai” MORE INFO NEEDED AND REFERENCES. WHAT IS THE DIFFERENCE BETWEEN A TRADE CENTRE AND AN ECONOMIC CENTRE?the relationship among the “four centres” is “3+1”,once the trade centre, financial centre and logistics centres are established, the economic centre is naturally formed.

9 See X, Planning key to free-trade zones (editorial), South China Morning Post (11 June 2014).

from exchange rate appreciation and increased labour costs, weak external demand owing to the slow recovery from the global financial crisis, the increasing trade frictions and the complicated customs regulatory processes that continue to turn away foreign capital and discourage domestic investment.[10]

The development of the CSPFTZ builds on Shanghai's strengths such as its excellent geographical location in terms of shipping and access to a vast and dynamic hinterland.[11] The choice for Shanghai as the location for China's push to host one of the world's premier tier financial centres also reflects the current reality of Shanghai as the de facto capital of finance of China.[12] Shanghai hosts the headquarters of the Bank of Communications and the Pudong Development Bank. The financial operations and the back office operations of respectively the China Industrial Bank and the China Ping'an Insurance Company are based in Shanghai. It is home to the Shanghai Stock Exchange, the Shanghai Futures Exchange, the Shanghai Gold Exchange, China Union Pay, the Foreign Exchange Trade System and the Interbank Market. It is then not surprising that it is the leading city in terms of the number of foreign financial institutions seeking a base in China.[13]

At the Third Plenary Session of the 18th Central Committee of the Communist Party of China (2013), a 'National Leading Group for Comprehensive Deepening Reform' was established. Among the responsibilities of this Group is the development of the CSPFTZ.[14] The Group is headed by President Xi Jinping and will take responsibility for the national policy design, inter-departmental and regional coordination and the implementation and supervision of major reform across sectors in furthering China's reform process.[15]

The WTO Trade Policy Review Report lists the initial achievements of the CSPFTZ as reported by the Chinese authorities. It reveals that in the period from September 2013 until mid-February 2014, 434 foreign-invested enterprises were established representing a total investment of US$1.8 billion. It was reported that these investors come from 40 different countries. The investments have been strongly attracted to services, including 89 financial companies were set up and 34 financial leasing

[10] Foreign companies have gradually moved their bases from the eastern coastal area to regions and countries that have low manufacturing costs(**Beresford et al.,2012) (Yang et al., 2010**),

[11] See Yizhi Wang, Hiroyuki Shibusawa, Edward Leman, Yoshiro Higano & Gouping Mao, A Study of Shanghai's Development Strategy to 2020, 5(2) Regional Science Policy & Practice 183 (2013).

[12] See Anindya K. Bhattacharya, The Feasibility of Establishing an International Financial Center in Shanghai, 12 Journal of Asia-Pacific Business 123-124 (2011).

[13] See Yizhi Wang, Hiroyuki Shibusawa, Edward Leman, Yoshiro Higano & Gouping Mao, A Study of Shanghai's Development Strategy to 2020, 5(2) Regional Science Policy & Practice 186 (2013).

[14] See WTO, Trade Policy Review China – Report by the Secretariat (WT/TPR/S/300) (27 May 2014), at 10; X, China's reform leading group holds first meeting (China Daily, 23 January 2014)

[15] See Third Plenary Session of the 18th CPC Central Committee, The Decision on Major Issues Concerning Comprehensively Deepening Reforms (12 November 2013) (abridged translation). Is there any public information available about this Group? How many members? Who? Any public information on their activities? Reports? Statements?

companies. The Zone currently represents 27% of Shanghai's total trade (exports and imports).[16]

As the title of the free trade zone indicates, this is a pilot project. Shanghai was chosen as the location for the pilot project as in previous cases with bonded zones and free trade ports. The pilot project has an initial period of two to three years to test further trade and investment liberalization with a focus on services, including testing new modes of services and new forms of supervision.[17] The experience gained through this pilot project is to serve nationwide as a model for new ideas, new approaches and further reform.[18] It is a strategic plan to ensure a more effective and efficient domestic financial sector ('serving the nation') and to further the internationalization of China's financial sector ('going to the world').[19] The pilot project allows experimentation 'step by step with risks under control'.[20] To date, more than 20 cities have a declared interest in being next in line when the results of this pilot are rolled out further, including Shenzhen, Tianjin, Qingdao, Chongqing and Xi'an. However, these new applications have been stopped by the Central government since they are still waiting for CSPETZ to show a 'duplicable and replicable experiences' and real impact.[21]

This article aims to review the regulatory aspect aspects of the financial reforms in the CSPFTZ and the arrangement for regulatory oversight. The first section reviews the regulatory framework and concludes that it does not yet meet international standards in terms of legal certainty, legal clarity and transparency and meaningful stakeholder involvement.[22]

No detail – the detail is to follow – most likely in a responsive mode: as problems or questions occur, the question is pushed up the chain to receive a response.

2. CSPFTZ Financial Services Liberalisation: Law and Institutions

2.1 Law and Institutions

[16] WTO, Trade Policy Review China – Report by the Secretariat (WT/TPR/S/300) (27 May 2014), at 51.

[17] See Article 2 (Overall Objectives), Decision of the State Council, Framework Plan for the China (Shanghai) Pilot Free Trade Zone (27 September 2013).

[18] See Article 2 (Overall Objectives), Decision of the State Council, Framework Plan for the China (Shanghai) Pilot Free Trade Zone (27 September 2013).

[19] See chapeau of Title 2, Decision of the State Council, Framework Plan for the China (Shanghai) Pilot Free Trade Zone (27 September 2013).

[20] See chapeau of Title 2, Decision of the State Council, Framework Plan for the China (Shanghai) Pilot Free Trade Zone (27 September 2013).

[21] **News of the Xinhua net(Chinese version) http://news.xinhuanet.com/politics/2014-06/03/c_126575983.htm Actually, this FTZ fever in China was originated from a formulation in the "Decision" of the Third Plenary Session of the 18th CPC Central Committee, that is "Based on practices in the China (Shanghai) Pilot Free Trade Zone, a number of qualified areas will be built into FTAs."(Article 24). However, some local governments are pursuing merely the preferential policies. It goes counter to the original intention of the central government which focuses on system innovation, deepen reform and further open up.**

[22] See also X, Planning key to free-trade zones (editorial), South China Morning Post (11 June 2014). The editorial summarises the problems cogently: 'The special measures outlined to attract foreign investors are short on detail. A "negative list" of areas and activities off-limits to investors runs to more than 1,000 items, leaving much red tape and a commercial legal framework and freedoms to do business that fall far short of international standards.'

The policy framework for the liberalisation of financial services is the decision of the Third Plenary Session of the 18th Central Committee of the Communist Party of China.[23] As part of the reform into a socialist market economy, a direction is charted to a modern market system with open, fair and transparent rules and markets-based prices.[24] Even though there are some exceptions to this development, financial services fall squarely within the policy and have been targeted for reform.[25] These reforms include allowing qualified private capital to set up financial institutions under enhanced supervision with a deposit insurance system and a market-based exit system, improve the market-based exchange rate formation mechanisms for the RMB and accelerate interest rate liberalisation.[26]

Whereas the policy direction is given by the Central Committee, the legal basis for the establishment of the CSPFTZ is provided by the 2013 decision of the State Council in pursuance of the afore-mentioned policy by issuing the Framework Plan for the China (Shanghai) Pilot Free Trade Zone.[27] The Guiding Principles of the Framework Plan provide that the CSPFTZ 'will create a regulatory environment on cross-border investment and trading that is in line with international practices, enhance China's economic position globally, and contribute to achieving the revival of the Chinese People's China Dream'.[28] The fourth 'major tasks and measures' of the Framework Plan deal specifically with strengthening innovation and further liberalization of financial services.[29] This strategy is focused on positioning Shanghai as a full-service international financial centre and internationalizing the RMB by opening up the CSPFTZ for private investors and foreign-invested and Sino-foreign financial institutions and by allowing financial innovations (including new areas of financial activities for China such as commodity futures trading, equity escrow, and cross-border RMB reinsurance).[30]

The Circular on the Framework Plan delegates the responsibility for the implementation of the Framework Plan to the Shanghai Municipal People's Government. [31]

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23 Insert reference

24 Insert reference

25 Insert reference which exceptions?

26 See Third Plenary Session of the 18th CPC Central Committee, The Decision on Major Issues Concerning Comprehensively Deepening Reforms (12 Nov 2013) (abridged translation), para. 18.

27 See Decision of the State Council, Framework Plan for the China (Shanghai) Pilot Free Trade Zone **(**27 September 2013**).**

28 Insert reference. Why revival?

29 The other three are: (1) Accelerate the functional transformation of government; (2) Opening up of investment sectors; (3) Promote the transformation of trade development approach; and (5) Improve regulatory supporting systems

30 Decision of the State Council, Framework Plan for the China (Shanghai) Pilot Free Trade Zone **(**27 September 2013**).**

31 See Circular of the State Council on the Framework Plan for the China (Shanghai) Pilot Free Trade Zone (18 September 2013).

Whereas the delegation to the Shanghai Municipal People's Government is explicitly stated in the Framework Circular, there is also some informal delegation of powers for the development of rules to the relevant agencies and bodies, in particular the People's Bank of China and to the three regulatory bodies of the financial sectors, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission. These bodies develop regulations on financial services liberalisation by issuing circulars and 'policies and measures'. These documents are quasi-legal in nature but they are in practice the applicable legal rules in the absence of being overruled.[32] However, these documents merely represent a further layer in the regulation in that they provide further implementation of the strategy but do not provide detailed rules. Examples include multiple references to 'qualified foreign-invested banks' or 'conditioned banks' but the conditions for qualification are left to decided.

A further level of details is to be developed by the **municipal government of Shanghai**, Shanghai Head Office of the PBC, China(Shanghai) Pilot Free Trade Zone Administration, **others** can develop detailed rules and procedures.

Insert paragraph on the institutions responsible for the implementation and functioning

2.2 The Opinion of the People's Bank of China (PBC Opinion)

The People's Bank of China is the highest level of implementation of the CPC Central Committee and State Council Decisions. It provides the three general principles that underpin the financial reforms[33]:

1. The principle of the financial sector serving the real economy will be followed to further facilitate trade and investment, promote the opening of the financial sector and to facilitate the FTZ to compete internationally on a higher platform.
2. The principle of continuing reform and innovation, and leading the way in pilot will be followed to promote the cross-border use of RMB, the move towards capital account convertibility, market-based interest rate reform and foreign exchange administration reform.
3. The principle of keeping risks within controllable ranges and making steady progress will be followed to organize experiments in an orderly manner whenever the conditions for an experiment are mature.

[32] See Peter Howard Corne, Creation and Application of Law in the PRC, 50 American Journal of Comparative Law 372 (2002). See generally Robert Guillaumond, Lu Jianping & Li Bin, Droit chinois des affaires 51-121 (Brussels : Larcier, 2013)

[33] **Opinions of the PBC on Financial Measures to Support the China (Shanghai) Pilot Free Trade Zone (unofficial translation, edited)**

The principles reflect the two main concerns. The first concern is to learn the lessons from the 2008 financial crisis by developing a cautious approach to financial liberalisation and to develop rules and regulations that aim to avoid speculative financial transactions by emphasising the linkage with the 'real economy' and by avoiding the pitfalls of the too-big-to-fail experiences in US and EU markets.[34] The second is to strengthen the market-reform and the internationalisation of China's financial sector, including the internationalisation of the RMB and the integration of the Chinese financial sector into the international markets.

The principles reveal important elements of the strategy. The reform and innovation process will be a gradual process. The objective is to keep the process under control and the steer its course. The purpose is to bring financial sector out of the state protective umbrella. This liberalisation is to support a reform of the Chinese financial sector and to facilitate its development into a sector that can sustain international competition. The facilitation of the CSPFTZ to compete internationally on a higher platform should be interpreted as a strategy of knowledge and know-how transfer and acquisition. By allowing foreign financial institutions to operate in the CSPFTZ and allowing them to enter into joint ventures, the Chinese financial institutions are forced to meet these increasingly higher benchmarks and become competitive at the international level as part of the efforts to make Shanghai a premier international financial centre built on Chinese financial institutions.

The second key element in the strategy is to position the renminbi as an international currency. This requires that the exchange of the renminbi is gradually released from strict controls and that the interest-rates are brought in line with the expectations of the market. The liberalisation of the usage of the renminbi includes the promotion of its cross-border use beyond simple trade payments. The most recent policy statement of the Shanghai Head Office of the PBOC was released on 21 February 2014 in the form of a 'Notice on the support of China (Shanghai) free trade zone to expand cross-border RMB test used'.[35] The Notice ….
The third key element concerns oversight and risk-management. It forestalls a wholesale review of the regulatory system. This issue will be discussed in the second part of this article.

2.3 The Circular of the China Banking Regulatory Commission (Banking Circular)

Banks operating in the CSPFTZ are not subject to the restrictions that are in force in China generally. The China Banking Regulatory Commission explains the effect of these changes for Chinese-funded banks and for qualified foreign-invested banks.[36]

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[34] Insert reference.to academic literature on 'real economy' link and financial crisis

[35] http://shanghai.pbc.gov.cn/publish/fzh_shanghai/2974/2014/20140221174612080116226/20140221174612080116226_.html

[36] *Circular of the China Banking Regulatory Commission on Issues Concerning Banking Supervision in China*

National Chinese-funded commercial banks, policy banks and banks in Shanghai can benefit from this new regulatory environment by setting up new branches or special institutions in the CSPFTZ, or by upgrading their existing presence to a branch or sub-branch.[37]

Qualified foreign-invested banks are similarly allowed to set up subsidiaries, branches or special institutions or to upgrade existing sub-branches to branches. Qualified foreign-invested banks can also set up Sino-foreign equity joint-venture banks.[38] As for Qualified foreign-invested banks, strict regulation applies in terms of the time-periods required to set up a branch by the representative office of a foreign bank in the CSPFTZ *and to be allowed to carry out RMB business.* The Circular indicated that a shortening of the time-periods will be studied. For setting up sub-branches the pre-approval procedure will be replaced by a reporting requirement for the qualifications of the branch office, the senior management and certain business permission.[39] **“A "green channel" will be set up to grant the market access for banking industry in the FTZ to enhance the administration efficiency by setting time limits for certain items.”** According to the WTO TPR, the Chinese authorities have explained that "Green Channel" means “streamlining the market access procedures for financial institutions by optimizing the supervision mechanism, so as to promote opening and competition among banks and financial institutions within the CSPFTZ”.[40]

The Banking Circular clarifies that qualified private investors can enter the banking sector in the CSPFTZ. They can set up banks, finance leasing companies, consumer finance companies and other finance institutions but they shall assume their own risk.[41] They can also participate in setting up Sino-foreign equity joint-venture banks with other Chinese or foreign financial institution investors.[42]

As was shown for private investors, the Banking Circular is not limited to banking but encompasses financial services in a wider sense and particular when it concerns cross-border investment and financing services. The activities of banking financial institutions supported by the China Banking Regulatory Commission include

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