

Financial Conglomerates in China: Legality, Model and Concerns

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Abstract:

Through recent amendments of its Commercial Bank Law and Securities Law, China has gradually softened its previous position mandating the segregation of financial business and supervision, as well as explored the financial conglomerate operation. Two models are considered in particular, namely the “universal bank” model, prevailing in Europe, and the “financial holding company” (FHC) model in the US. This Paper suggests that now neither the universal bank nor the FHC model should be embraced hastily in China without a critical eye. While the FHC sounds a likely choice, it contains drawbacks and unfitness that merit discussion. The choice of models largely relies upon a careful reading of legal, factual and historical contexts. Transforming State Owned Commercial Banks (SOCB) and other financial institutions into the public-held and independent companies shall be a prerequisite and propellant to any meaningful structural reform, including the financial conglomerate issue.

Key words:

Financial Conglomerate, Financial Holding Company, Universal Bank, Model Evolution, Path Dependence

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In the past ten years, China took the general position of separating different financial businesses, and putting them under segregated supervision. Nonetheless, recent amendments to the Commercial Bank Law and Securities Law seemed to open the door for financial conglomerate operations. Two models have been considered in particular, namely the “universal bank” model, prevailing in Europe, and the “financial holding company” (FHC) model in the US. Through theoretic analysis and review of the latest development, this paper suggests that at China’s current stage neither the universal bank nor the FHC model should be embraced hastily without a critical eye. While the FHC seems a likely choice, it contains drawbacks and unfitness that merit discussion. Transforming State Owned Commercial Banks (SOCB) to public-held and truly independent entities shall certainly be a prerequisite and propellant to any meaningful structural reform, including the financial conglomerate issue.

Part I. Law Amendments in China

Before 1978, when China began its reform, banks in China had functioned like government bureaus, playing the role of allocating capital under the central-planned economy scheme.¹ Thanks to the market liberation, they groped to learn how to be independent and operate like “real banks.”² To provide the foundation for the development of safe, liquid, and efficient commercial banks,³ China promulgated the Commercial Bank Law in 1995, in which Article 43 provided that:

Commercial banks shall not be permitted to engage in trust investments and stock operations and shall not be permitted to invest in real estate within the territory of the People’s Republic of China that is not for their own use, shall not be permitted to invest in non-banking financial institutions and enterprises within the territory of the People’s Republic of China. In the event that a commercial bank has already invested in non-banking financial institutions and enterprises prior to the implementation of this Law, the State Council shall stipulate implementation measures separately.⁴

The principle of separation between banking and securities activities was also reiterated and stressed in the Securities Law enacted in China,⁵ which mandated that:

Securities business shall be engaged in and administered as a business separate from the banking business, trust business and

¹ Andrew Xuefeng Qian, *Transforming China’s Traditional Banking System Under The New National Banking Laws*, 25 GE. J. INT’L & COMP. L. 479, 481 (1996).

² *Id.* at 488.

³ Commercial Bank Law, art 4.

⁴ The State Council or the Central Bank through authorization set a timetable for those banks to phase out of the securities business.

⁵ The law was passed on Dec. 29, 1998 and took effect on July 1, 1999.

insurance business. Securities companies shall be established separately from banks, trust companies and insurance companies. (Art.6)

The flow of bank funds into the stock market against regulations is prohibited. When carrying out business on its own account, a securities company shall use its self-owned funds and funds raised according to law. (Art. 133)

Those articles were designed to curtail the influx of funds from commercial banks, in particular to deter the wholly SOCB from entering China's then fledgling securities markets. Two stock exchanges (Shanghai and Shenzhen) of China opened successively in 1990 and 1991, formally symbolizing the comprehensive restoration of China's securities business. Still in an early stage, China's stock market was comparatively small and stock prices often volatile. Moreover, state-held corporations made up the majority of listed companies, a fact that explains many unique features of China's securities market.

Unlike that in Southeast Asia, the "hot money" that plagued China's stock market in the early 1990s was not from foreign hedge funds, since China had yet to open its door to currency convertibility under capital accounts. Actually, loans by commercial banks were blamed as the major source of speculative funds. With economic development, household savings and deposits from enterprises had grown rapidly since 1980s. At the same time, external regulations restricted banks from making loans to their former main clients – state owned enterprises, while internal efforts to control risks made them reluctant to do so.⁶ Faced with deposits in excess of loans, commercial banks had a strong incentive to divert some funds into speculative outlets and reap more gains.⁷ Banks often transferred funds to their affiliated Trust and Investment Companies (TICs) that could directly engage in securities activities or re-lend capital to securities companies. By doing so, commercial banks were able to circumvent the then effective credit controls on the banks themselves.

Commercial banks played a major role in China's financial system. Among these banks, the four SOCBs dominated,⁸ which were described as the "the only financial institutions with muscle."⁹ The use of funds from these banks for manipulative securities practices wreaked havoc on China's emerging stock market, and had the potential to ruin the banks themselves and ultimately the whole economy. These misgivings motivated China to decide in 1995 to separate commercial banking from non-banking activities, either directly or through TICs under their purview.

⁶ Solomon M. Karmel, *Securities Markets And China's International Economic Integration*, 49 J. INT'L AFFAIRS 525, 526 (1996).

⁷ *Deposit Figures Highlights Progress*, S. China Morning Post, Sept. 14, 1995, at 6.

⁸ The four state owned commercial banks are the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the China Construction Bank (CCB), and the Bank of China (BOC).

⁹ Dede Nickerson, *Business News*, S. China Morning Post, May 15, 1995, at 4.

Things change as time passes, and so for policy and law. After Japan and the U.S. successively pulled down their Glass-Steagall walls, which had imposed a strict separation between commercial banking and securities activities, proposals poured in for China to reconsider its position by revising or repealing the related provisions. On December 27, 2003, the Standing Committee of China's National People's Congress passed thirty-seven amendments to the Commercial Bank Law,¹⁰ including an amendment to Article 43:

Commercial banks shall not be permitted to engage in trust investments and stock operations and shall not be permitted to invest in real estate within the territory of the People's Republic of China that is not for their own use, shall not be permitted to invest in non-banking financial institutions and enterprises within the territory of the People's Republic of China. The foregoing shall not apply where the State has rules stipulating otherwise. (*Emphasis added.*)

On October 27, 2005, the amendment to Securities Law brought similar changes to the related provisions:

Securities business shall be engaged in and administered as a business separate from the banking business, trust business and insurance business. Securities companies shall be established separately from banks, trust companies and insurance companies. The foregoing shall not apply where the State has rules stipulating otherwise. (Article 6, *emphasis added.*)

Channels for the flow of funds into the market shall be widened, and the flow of funds into the stock market in violation of regulations is prohibited. (Article 81)¹¹

Those changes suggest that if and when the State deems appropriate, it can promulgate rules or regulations, authorize commercial banks to cross the line into the securities business, and vice versa.¹² Though it is not clear if the State in those amendments is the State Council or some other body, such as National People's Congress or its Standing Committee, the path seems to be paved for banks and securities companies to evolve into financial conglomerates, either by self expansion or through affiliation. Two different models have been often discussed to achieve such transformation—the European universal bank model and the US financial holding company model (FHC).

¹⁰ All amendments took effect on February 1, 2004.

¹¹ Effective on January 1, 2006.

¹² LU Xue, *Report: ZHOU Zhengqing Talks on the Forthcoming Revision of Securities Law*, at http://www.fsi.com.cn/celeb300/visited303/303_0312/303_03123001.htm (last visited Mar. 16, 2007). Mr. ZHOU Zhengqing is the former chairman of China's Securities Regulatory Commission (CSRC), and currently serves as the Associate Chairman, Fiscal & Financial Sub-Committee, Standing Committee of China's National People's Congress. He was also in charge of the then ongoing amendment to Securities Law.

Part II. The Universal Bank Model

Traditionally, in those European countries such as Germany, Italy, Switzerland and the Netherlands, commercial banks were licensed to participate in the securities services and a broad array of other financial services. Under the German model, universal banks “can perform a wide variety of financial services including taking deposits, making loans, underwriting securities issues, dealing in precious metals and collectible coins, and brokering real estate.”¹³ Acclaiming such banks as the “backbone of the rapid and successful German industrialization of the late nineteenth century”,¹⁴ William L. Horton, Jr. identified four specific characteristics of the German banking system that contributed to its successful development:¹⁵ (1) close ties to industry;¹⁶ (2) independent decision making; (3) competent central bank and active regulatory support; (4) specialization of functions.

The EU Second Banking Directive (SBD) in 1989 provided that¹⁷ EU banks, securities firms and most foreign institutions participating in the “single market” may engage in a qualified “universal banking,” which allows a bank to transact commercial and investment banking functions within the same corporate entity.¹⁸ To create a “level playing field”, the SBD embraced three principles:¹⁹ (1) Mutual Recognition, which mandates that if a service can be provided legally under specific conditions in one EU country, it cannot be proscribed under similar conditions in another EU country;²⁰ (2) a Single Banking License, which means that once a bank is licensed by the proper authorities in its home country to engage in certain activities, it is permitted to transact those same activities in any other Member State under the single banking license, without need to get permission in the host country,²¹ and (3) an agreed-upon list of banking activities. Article 18 (1) of the SBD provides that EU countries must allow the activities listed in the Annex to the Directive to be carried on within their territories, and those activities are covered by home state authorization.²² These specified activities include not only the traditional banking services of accepting deposits and lending, but also most of the services that investment banks traditionally provide such as trading and underwriting securities, portfolio management, corporate finance, and mergers and acquisitions services.²³

¹³ William L. Horton, Jr., *The Perils of Universal Banking in Central and Eastern Europe*, 35 VA. J. INT’L L. 683, 684 (1995)

¹⁴ *Id.* at 685.

¹⁵ *Id.* at 692.

¹⁶ For example, German universal banks often gained membership on the board of directors of their industrial customers and assumed a large influence over the firm’s governance by exchanging capital for large equity stakes in their clients.

¹⁷ Formally speaking, the SBD has been superseded by Directive 2000/12/EC of the European Parliament and the Council, March 20, 2000, that codified the SBD along with other legislation relating to banking, e.g., the Capital Adequacy Directive. However, the substance of the SBD remains unchanged.

¹⁸ Joseph J. Norton & Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory—Market “Partnership*, 16 ANN. REV. BANKING L. 227, 252 (1997).

¹⁹ George S. Zavvos, *Banking Integration and 1992: Legal Issues and Policy Implications*, 31 HARV. INT’L L. J. 463, 482 (1990).

²⁰ ALFRED LEWIS & GIOIA PESCIOTTO, EU AND US BANKING IN THE 1990S 12–13 (1996).

²¹ *Id.*

²² *Id.*

²³ Norton/Olive, *supra* note 18, at 253.

The application of these principles resulted in competition for deregulation between the regulatory agencies of each member country, because one country's bank may achieve a competitive advantage over another country's bank by providing domestic customers with products that domestic banks are proscribed from offering, but that are permitted by the SBD.²⁴ Thus, all other EU countries had a strong incentive to move towards the least restrictive German universal bank model,²⁵ which actually resulted in a competitive de-regulation of the financial services in the EU financial services industry.²⁶

The SBD illustrated some fundamental ideas. First, the EU believes that diversification, through participation in the securities industry, adds depth and liquidity to commercial banks.²⁷ Second, the EU assumes that the securities activities of banks help them maintain overall earnings when the conventional banking business is suffering from decreased profits.²⁸ Third, the EU views the more flexible universal banks as a powerful means to compete in the global financial marketplace.²⁹ Some academic research also showed that shares of universal banks embody substantial franchise value, which serves to inhibit extraordinary risk-taking.³⁰

The SBD left supervision to the home countries. Then a 1992 Council Directive established the principle of consolidated supervision of the various entities within a banking group.³¹ In April 2001, the European Commission proposed a Directive to deal with financial conglomerates, which was then agreed upon by the Council in May 2002.³² Among other things, this Directive seeks to insure that the same capital is not used to support different regulated institutions, as well as to address supervisory concerns on intra-group transactions.

At first glance, both Germany and China seem to have an underdeveloped securities market.³³ Like the age-old question of whether the chicken or the egg came first, the relationship between uncompetitive securities markets and universal banks runs in such a self-reinforcing cycle,³⁴ which supports the idea that China ought to adopt that

²⁴ LEWIS/PESCETTO, *supra* note 20, at 12.

²⁵ *Zavvos*, *supra* note 19, at 483.

²⁶ LEWIS/PESCETTO, *supra* note 20, at 13.

²⁷ *Zavvos*, *supra* note 19, at 481.

²⁸ *Id.*

²⁹ *Id.* at 482.

³⁰ Rebecca S. Demsetz, et al., *Banks with Something to Lose: The Disciplinary Role of Franchise Value*, 2 FED. RES. BANK OF N.Y. ECON POL'Y REV., Oct. 2, 1996 at 1-4.

³¹ 92/30/EEC (April 28, 1992).

³² John F. Mogg, *Regulating Financial Services in Europe: A New Approach*, 26 FORDHAM J. INT'L LAW 58 (2002).

³³ Gerhard Wegen, *Colloquium: Transnational Financial Services- Current Challenges for an Integrated Europe*, 60 FORDHAM L. REV. 91, 104 (1992). This article states that in Germany, of 2,500 stock corporations, only 650 corporate entities were listed on any German stock exchange by May 1992; of these listed corporations, approximately thirty account for three fourths of all turnover on the German stock exchange. Comparatively, Germany has approximately 350,000 limited liability companies, 30,000 general partnerships and 130,000 limited partnerships.

³⁴ Amy Chunyan Wu, *PRC's Commercial Banking System: Is Universal Banking a Better Model?*, 37 COLUM. J. TRANSNAT'L L. 623, 634 (1999).

model. In terms of scale and degree of concentration, China's banking system also resembles the German banking system more closely than that of the US.³⁵ Particularly in the above four characteristics pinpointed by William L. Horton, Jr., "ties to industry"³⁶ and "specialization of functions" are characteristics of both countries.

However, the dissimilarities in the other two characteristics cast serious doubt on the appropriateness of the universal bank model for China. Created as private entities, German banks are free from control by the government or their clients. While they maintain close ties with their customers, they are not known to shy away from asking tough questions when making loans. In addition, German bankers have the skills and experience to make efficient allocation decisions.³⁷ Notwithstanding legislative provisions emphasizing the independence of banks,³⁸ China's banks lack the autonomy and capacity of their German counterparts.

Moreover, the establishment of the universal bank system in Germany benefited from the presence of an active and competent central bank to ensure the system's stability.³⁹ Both People's Bank of China as the central bank and China's Banking Regulatory Commission as the current major banking regulator clearly still have a long way to go in this respect. Furthermore, concerns have also been raised that because the universal bank model features a close connection between banks and industries, it might drag China back to the old track of the planned economy, or to the bank-enterprise distress chain that obsessed Japan.

Part III. The Financial Holding Company Model

By comparison, the US style FHC approach seems more innovative and has gained more popularity during the past few years in China. Some comprehensive financial holding group companies have emerged in China: for instance, the Everbright Group, which had two banks, two securities firms, and one life insurance business in cooperation with a Canadian insurance company, officially announced its exploration as FHC in the summer of 2007. Other cases include the renowned China International Trust and Investment Corporation Group (CITIC Group), the Ping An Insurance Group derived from an insurance giant, etc. They are at the forefront of the development of US-styled FHCs in China and constitute a very influential interest group lobbying for legislative accommodation and administrative adjustments.

³⁵ YANG HAIQUN, *BANKING AND FINANCIAL CONTROL IN REFORMING PLANNED ECONOMIES* 76 (1996).

³⁶ Although legally Article 43 of Commercial Bank Law bans commercial banks from investing in enterprises within the PRC, historically, state specialized banks and state owned enterprises maintained an intertwined relationship. Even now, to some extent and in some form, such interconnections still remain.

³⁷ *Horton, Jr., supra* note 13, at 696.

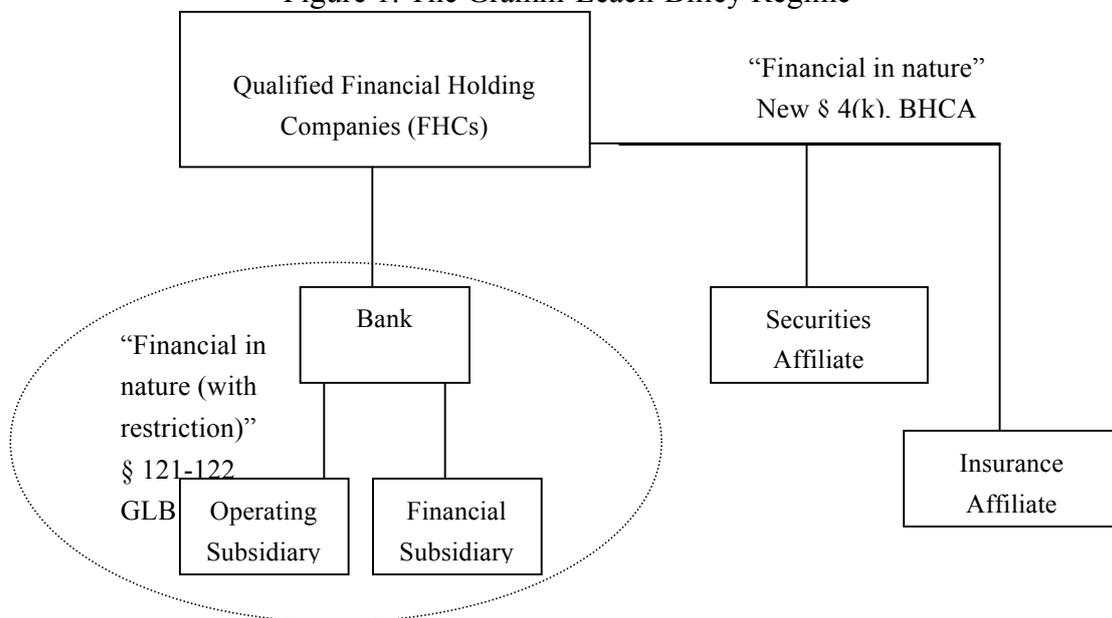
³⁸ For example, Commercial Bank Law, art. 4.

³⁹ *Horton, Jr., supra* note 13, at 700.

With the Glass-Steagall Act passed in 1933, banking, securities and insurance in the US were for decades carefully segregated with separate regulation.⁴⁰ However, recent legislation has relaxed restrictions on affiliations among companies in these different fields and emphasized operation of different functions from separate companies within a group of related companies. The Gramm-Leach-Bliley Act (GLB Act, Financial Modernization Legislation) enacted on November 12, 1999 substantially overhauled the Glass-Steagall Act, and brought about some fundamental changes.

First, the GLB Act expressly repealed Sections 20 and 32 of the Glass-Steagall Act, eliminating the restrictions on banks and securities firms from affiliating and sharing personnel. Second, it created a holding-company structure by amending the Bank Holding Company Act to include a provision applicable to financial holding companies. Under the GLB Act, companies engaged in commercial banking, investment banking and insurance activities may be owned and operated by a single FHC as long as the business conducted is “financial in nature or incidental to such financial activity, or complementary to a financial activity and does not pose a substantial risk...” Third, purporting to streamline the FHC supervision, the GLB implicitly designated the FRB as the umbrella regulator of FHCs, with functionally regulatory authority over the commercial banks, investment banks, and insurance companies in the structure delegated to the appropriate regulators.

Figure 1: The Gramm-Leach-Bliley Regime



As a whole, the US stock market reacted positively to the passage of the GLB Act. When President Clinton announced the Act, both commercial and investment bank stocks rose.⁴¹ Studies also showed that the market responded most favorably to the

⁴⁰ The Glass-Steagall Act was actually the popular name for §§16, 20, 21 & 32 in the Bank Act of 1933.

⁴¹ Cara Lown, et al., *The Changing Landscape of the Financial Service Industry: What Lies Ahead?* 6 FED. RES.

shares of BHCs that had already engaged in some securities businesses (those with Section 20 subsidiaries allowing limited investment banking activities).⁴²

On the other hand, doubts remain relating to the soundness of such changes. For instance, was the repeal of Glass-Steagall appropriate? Some critics in the US remain suspicious that safeguards designed in the GLB are not sufficient to eliminate hazards such as conflicts of interest, and even less safeguards are available to resolve emerging problems such as undue encroachment upon consumer privacy.⁴³ In their view, the “subtle hazards” that justified the Glass-Steagall wall are still legitimate concerns and are not being handled appropriately by the GLB.⁴⁴ As once expressed by the US Supreme Court in *Investment Company Institute v. Camp*,⁴⁵ such “subtle hazards” that occur when a commercial bank enters into the business of investment banking directly or indirectly through an affiliate include: (1) an adverse effect on public confidence if the bank or affiliate performs poorly because of the association in the mind of the public; (2) the risk of unsound loans to the ailing affiliate in an effort to raise public confidence; (3) the risk that the bank may provide credit more freely to companies in which the affiliate has a vested interest; (4) the risk that the bank may act more as a salesman than as an unbiased source of credit; (5) the risk that customer goodwill will diminish if losses are incurred because of the affiliate; (6) the loss of reputation for prudence and restraint because of investment banking needs; (7) the temptation to make loans merely to facilitate the purchase of more securities; (8) conflicts of interest between the need to offer impartial advice as a commercial bank and the salesman’s interest as an investment bank.⁴⁶

In 2003, the US Congress considered whether to cut back on the GLB due to concerns about conflicts of interest between the banking and securities businesses of FHCs, for example, the concern that banks were tying loans to underwriting. Similar “mixed bundling” abuses included that the price of lending was dependent on the client also taking another service, like M&A advice. Nevertheless, some opined that such worries were unfounded because such tying would have already been prohibited by the anti-tying provision of the BHCA (§ 106), at least where a bank “coerces” a customer to buy the tied product.⁴⁷ Moreover, such coercion could not exist unless the bank had more leverage in the lending market, which is unlikely in the current situation.

BANK OF N.Y. ECO. POL’Y REV., Oct. 2000, at 39–55.

⁴² YU LI, *On the Wealth and Risk Effects of the Glass-Steagall Overhaul: Evidence from the Stock Market*, New York University (2001) (unpublished manuscript, on file with author).

⁴³ HOUSE COMMERCE WRANGLE WITH PRIVACY IN APPROVING FINANCIAL SERVICES MEASURE, BANKING POL’Y REPORT, VOL. 72, No. 24 (1999).

⁴⁴ Joan M. LeGraw & Stacey L. Davidson, *Glass-Steagall and the “Subtle Hazards” of Judicial Activism*, 24 NEW ENG. L. REV. 225, 225–28 (1989).

⁴⁵ 401 U. S. 617 (1971).

⁴⁶ *Id.* at 630–37.

⁴⁷ FEDERAL RESERVE BOARD, PROPOSED INTERPRETATION OF SECTION 106 OF THE BANK HOLDING COMPANY ACT, (Aug. 25, 2003).

As of April 2003, there were 639 FHCs formed in the US, including about twenty by foreign banking organizations. Only a small number of large FHCs have purchased securities firms since the enactment of the GLB. Instead, FHCs have mainly been used to free holding companies from restrictions placed on existing securities affiliates, such as limits on underwriting and dealing twenty-five percent of the securities affiliate's revenue. Similarly, no FHC has acquired a large insurance company since the Citi-Travellers, which was prior to the enactment of the GLB.

Moving back to the focus of this paper, should and could China continue to follow the US' suit and readily embrace the FHC model? Further concerns deserve attention. First, some inherent problems of FHCs have to be carefully dealt with, for instance, those relating to capital adequacy, corporate governance, and risk control: (1) Capital adequacy: A poorly regulated holding company might finance the capital of its subsidiaries through the excessive issuance of debt instruments, or a subsidiary might use its assets to capitalize its affiliate, which would lead to double or even multiple accounting of limited capital within the FHC. (2) Corporate governance: Diversified businesses present more challenges to the internal control of improper interest transfers, and the endogenous systematic risks of the financial industry make the problem even subtler. (3) Risk control: Based on US data from 1971 to 1987, a test of hypothetical mergers showed that mergers between BHCs and insurance companies could have reduced risk, while mergers between BHCs and securities firms could have increased risk.⁴⁸

The problem of conflict of interest deserves particular attention. In 2001 and 2002, even Citigroup and J.P. Morgan were troubled by US corporate scandals involving conflicts of interest, and both lost over a third of their market value in a short period. In the meantime, the issue of transparency eventually forced a breakup of GE Capital's organizational structure. Preventing conflicts of interest inherent within the FHC proves expensive, since compliance systems are costly to maintain, and various types of separation mechanisms between business units can have high opportunity costs, because they give rise to inefficient uses of information and other resources within the organization. Moreover, the contagious character of loss of reputation can be quite severe.⁴⁹ It demands enormous effort to strike a subtle balance and accommodate various interests properly. For a country like China lacking prior experience and preparation in this field, a long period of trial and error might well be necessary.

Second, the vast differences between the US and China should not be underestimated when deciding what approach to take. As a whole, the GLB of 1999 was intended to level the playing field and enhance competition in the financial service industry⁵⁰ by

⁴⁸ John Boyd, et al., *Bank Holding Company Mergers with Non-bank Financial Firms: Effects on the Risk of Failure*, 17 J. FIN. ECO. 43-63 (1993).

⁴⁹ INGO WALTER, STRATEGIES IN FINANCIAL SERVICES, THE SHAREHOLDERS, AND THE SYSTEM: IS BIGGER AND BROADER BETTER? BROOKING-WHARTON PAPERS ON FINANCIAL SERVICES 21 (Brookings Institution Press 2003).

⁵⁰ See Preamble of this Act.

affording disadvantaged commercial banks a means of competing with powerful securities firms. In China, the situation is quite different. There is no Goldman Sachs, Merrill Lynch, Morgan Stanley, or similar sophisticated investment players. Before the 1995 separation, China's largest securities firms were supported by state-owned commercial banks.⁵¹ Even now, the scale tips heavily in favor of commercial banks.

In China, to the extent that they are subsidized or supported informally by the government, SOCBs have a strong incentive to make speculative bets because any gains will be fully recouped, whereas losses will be partially shared with the government.⁵² Conceivably, such a strong interest will challenge the accountability of the FHC, which has never been stringently checked in this way in the US. The related Too-Big-To-Fail (TBTF) and moral hazard problem exist in the US,⁵³ and many other countries.⁵⁴ However, the feature of state ownership in China with respect to the four SOCBs and major securities firms would render the TBTF problem even worse.

Among the four SOCBs, China Construction Bank (CCB) became a joint stock company in 2004 and was listed on the Hong Kong Stock Exchange in 2005. The year of 2006 first witnessed the triumph of the Bank of China (BOC) in its oversubscribed public offer and listing consecutively in HK and Shanghai. Subsequently, Industrial and Commercial Bank of China (ICBC) set the new world record for IPO capitalization. With ease, recapitalized and rejuvenated commercial banks paled by comparison those troubled securities firms. Eliminating the separation completely and immediately in China may have the potentially undesirable effect of decreasing competition, rather than the opposite.

Furthermore, I believe that for those banks, there are changes equally or even more crucial and urgent than simply transfiguring into an FHC or re-expanding into the capital market. First, in tandem with the divestiture by the State, these banks should undertake a thorough reform and become publicly held corporations with sound governance structures. Second, they should keep improving their operating efficiencies and cutting down non-performing loans. After all, in most cases how things are done is more important than what things are done. Studies suggest that the way banks are run is of more weight than their size or the type of business they pursue.⁵⁵ At the same time, empirical research has failed to find significant cost economies of scope in financial industries.⁵⁶

⁵¹ Nickerson, *supra* note 9.

⁵² However, legally speaking, Commercial Banking Law Art. 4 specially made banks responsible for their profits and losses.

⁵³ Maureen O'Hara & Wayne Shaw, *Deposit Insurance and Wealth Effects: The Value of Being "Too Big to Fail"*, *Journal of Finance* Dec. 1990 at 1587.

⁵⁴ See for example, US GENERAL ACCOUNTING OFFICE, *DEPOSIT INSURANCE: OVERVIEW OF SIX FOREIGN SYSTEMS*, GAO/NSIAD-91-104 (1991).

⁵⁵ For example, Allan N. Berger, et al., *The Efficiency of Financial Institutions: A Review and Preview of Research Past, Present and Future*, 17 *J. BANKING & FIN.* 221-49 (1993).

⁵⁶ For example, Chris Stefanadis, *Specialist Securities Firms in the Gramm-Leach-Bliley Era*, Federal Reserve Bank of New York (2002) (*unpublished manuscript, on file with author*).

Third, potential regulatory restructuring presents another pragmatic problem in China. Back in 1992, as the central bank, People's Bank of China was the sole regulator in the financial area. In October 1992 and November 1998, China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC) were established successively, and have been in charge of supervising the securities and insurance industries, respectively. The latest structural adjustment occurred on April 2003, when the newly formed China Banking Regulatory Commission (CBRC) officially started operations. The CBRC is authorized to supervise and regulate banks, assets management companies, trust and investment companies and other deposit-taking institutions, with the aim of safeguarding the legitimate and sound functioning of the banking industry. Now People's Bank of China's main mandate is to formulate and implement monetary policy.

Obviously, the full range of businesses engaged in by the FHC calls for a higher degree of cooperation and coordination among banking, securities, and insurance regulators. The current form of linkage between China's regulators is a joint forum, which can barely meet this requirement. With the development of FHCs, who should become the main, or umbrella, regulator (if taking FRB model)? Or should they undergo another round of merger and functional re-streamlining (if taking FSA model)?⁵⁷

Resolving regulatory conflicts might be knottier than it first appears, when activities and transactions begin to straddle formerly distinct jurisdictions. On the one hand, from a historical and philosophical viewpoint, a centralized approach seems better suited for countries like China and Japan. Their experience is markedly different from the US's strange and stubborn sense of federalism and checks and balances, which result in certain powers being intentionally divided and kept to the states or separate agencies. But, will an FSA-styled bureau in China repeat the failure of the PBOC in the early 1990s to oversee the whole financial market, which has increased greatly in volume and become more complex in nature?

Needless to say, a cost benefit analysis will be taken by the decision maker, not only from an economic perspective, but also in political and personnel terms. Chinese traditional wisdom states, "a long time of integration leads to separation, whereas a long time of separation leads to integration."⁵⁸ For many people, a uniform FSA suggests an immediate reverse of the just completed specialization process. As in the US and other foreign countries, redistributions of interest and power shifts will raise new debates and struggles, making a consensus difficult to reach in the near future.

⁵⁷ In May 1997, the United Kingdom announced a total restructuring plan of its regulatory regime for financial services, including combining banking supervision and securities regulation under a new agency called the Financial Supervisory Authority (FSA), which was implemented in 1998. Japan, Taiwan and others took similar action.

⁵⁸ "He2 Jiu3 Bi4 Fen1, Fen1 Jiu3 Bi4 He2".

On the 19th and 20th of January 2007, a group of Chinese top level governmental officials gathered in Beijing and held the Third National Financial Work Conference chaired by Premier Wen. This Conference decided to postpone any plan to merge the currently separate financial regulatory bodies into one single agency. Rather, People's Bank of China and the three regulatory commissions would continue to operate separately, and work on improving their effectiveness and professional capability, as well as enhancing collaboration therewith.

Fourthly, two categories of latest development increased concerns regarding the FHC and its hybrid. For governmental experiments, China's central government set up the SAFE Investments – Huijin through foreign exchange reserve injection, which modeled Temasek or GIC in Singapore and gradually controlled commercial banks such as CCB, BOC and ICBC, as well as some major securities firms, and possibly China Development Bank in future. Plan has it to merge Huijin into and make it as the subsidiary of the newly established China Investment Co. Ltd.

At local levels, similar or even more aggressive movements took place. For instance, Yufu Asset Management Company was established in Chongqing, the largest municipality of China. Yufu started to buy bad assets from local banks and sell them back to local businesses at a discount. Backed by loans from China Development Bank, Yufu has dramatically expanded its business, reorganizing struggling SOEs and restructuring local financial institutions. In 2006, the company has also begun to make strategic investments on behalf of the Chongqing government.⁵⁹ Some critics believe that such action works to blur the line that should be drawn between financial and industrial sectors, and represent a possible retrogradation towards the all-around and inefficient governmental entity.

Private companies that probed the FHC style too with the desire to maximize their interest, often fell into the abyss of disgrace and crime, among which the most notorious example is the Delong Group. Initially incorporated in Xinjiang (Sinkiang) Vygur Autonomous Region and then headquartered in Shanghai, Delong's story started with three siblings beginning an ambitious grass-root entrepreneurial business that engaged in maverick business expansion and disastrous stock speculations. Market manipulation and loss created a desperate desire to control and exploit financial institutions for its subsidiaries' parasitic survival. Therefore, Delong strived to control TICs, securities firms and local banks through acquisition, and eventually became the de-facto private financial conglomerate.⁶⁰

Subsequent investigation discovered that Delong proved to be a huge financial black hole and had accumulated more than two billion US dollars in un-payable losses. When things went sour and its controlled stock prices nose-dived in 2004, twenty billion RMB in market value evaporated within ten days. The head of Delong – Mr.

⁵⁹ LI Zhiqiang, et al., *Report: Chongqing Builds Financial Holding Firm*, *Caijing Magazine*, Apr.3, 2006, at 73–81.

⁶⁰ LING Huawei, et al., *Report: Finale in Sight for Delong Sage*, *Caijing Magazine*, Jan.9, 2006, at 38–63.

TANG Wanxin, stood trial on April 29, 2006 on charges of illegal public deposit taking and manipulating stock prices. He was convicted and sentenced to an eight year imprisonment and a 400,000 RMB personal criminal fine. As for the Delong Group, a 1.3 billion US dollars company was imposed, which was deemed as most likely uncollectable by analysts. The Delong incident demonstrated what devastation can occur when the FHC becomes off the track, as well as the failure of the current supervision of such companies.

Part IV. Japan: A Parallel Explorer

The Japanese banking system is highly specialized and segregated, with each type of banking institution specializing in particular market or product segments.⁶¹ For about half of a century, Japan was known as the only other major developed country that followed the US model for regulatory separation.⁶² Upon the insistence of the US during its occupation of Japan following the second world war, Japan enacted Article 65 of the Japanese Securities and Exchange Law which, imitating the Glass-Steagall Act, imposed a strict separation between commercial banking and securities activities.⁶³

Since the 1980s, Japanese banks have been seeking entry into the securities business. They lobbied for ending Article 65 barriers, whereas securities firms were resistant.⁶⁴ During the 1990s, the Japanese government took steps to make a change.⁶⁵ The Financial System Reform Law of 1993 abolished in principle the firewall between banks and securities firms.⁶⁶ Securities firms were permitted to offer some products with features like bank accounts, such as automatic deposits, demand deposits, and automatic payments. Nevertheless, due to strenuous Ministry of Finance (MOF) licensing procedures, the entry of banks into the securities business remained slow and heavily controlled.⁶⁷

In March 1998, financial firms were allowed to create holding companies for “one-stop shopping” financial conglomerates (i.e., companies that included banking, brokerage and insurance functions under one roof).⁶⁸ In 1999, there was a further reduction of the barriers preventing banks, trust banks and securities firms from entering each other’s markets.⁶⁹ Now Japanese banks are permitted to engage in a full

⁶¹ Norton/Olive, *supra* note 18, at 279.

⁶² Peter J. Ferrara, *The Regulatory Separation of Banking from Securities and Commerce in the Modern Financial Marketplace*, 33 Ariz. L. REV. 583, 615 (1991).

⁶³ Some, however, opined that the Keiretso in Japan actually bypassed such segregation through cross holding between each other.

⁶⁴ Richard Katz, *Japanese Phoenix: The Long Road to Economic Revival*, M.E.Sharpe (2003), at 212.

⁶⁵ J.Barth, et al, *Commercial Banking Structure, Regulation and Performance: An International Comparison*, Office of the Comptroller of the Currency Economics Working Paper (1997) (*unpublished manuscript, on file with author*).

⁶⁶ Sarah A. Wagman, *Laws Separating Commercial Banking and Securities Activities as Impediment to Free Trade in Financial Services: A Comparative Study of Competitiveness in the International Market for Financial Services*, 15 Mich. J. Int’l. L. 999, 1013 (1994).

⁶⁷ Katz, *supra* note 64, at 213.

⁶⁸ *Id.*, at 214.

⁶⁹ *Id.*

range of securities and insurance activities through subsidiaries. Japanese holding companies have been permitted, but only a few banking organizations have established them. The activities that banks and non-bank holding companies can engage in are the same.⁷⁰

At the regulatory level, the new Financial Service Agency (FSA) was created in 2001. The FSA amalgamated its two transitional predecessors, the Financial Supervisory Agency and the Commission for Financial Reconstruction, which controlled government funds injected into the banks. Now the FSA licenses, inspects and supervises banks, securities firms, and insurance companies, as well as managing and resolving financial crises. MOF continues to make policy and draft financial legislation.

Part V. Conclusion

The deregulation of the financial industry is a global trend, particularly because it satisfies clients' need for easy access to comprehensive, value-added and prompt financial services. Hence changes to China's financial regime seem inevitable in the future. Whatever the conglomerate model adopted, the unified and highly centralized control of the financial system by the State or its agents must change. China has paid too much for it. In the planned economy era and for many years thereafter, SOEs made up the majority of clients of the state-owned specialized banks, and their successors, the SOCBs. The nature of the loan was of policy, not of business. The primary character of such policy-natured loans was that the bank did not give much consideration to the risk, efficiency, and negotiability of the loan program. With respect to loans to the SOEs, what the SOCBs mainly considered was the execution of the national macro-economic policy, the purpose and the effect of national macro-control. Therefore, many loans were deemed as part of the government's administrative management rather than a business operation. In more and more situations, the SOEs could not repay the principal and interests accrued due to various reasons. Thus, the huge Non-Performing Loans of the SOCBs were accumulated up.

I hope that through incorporation and listing, the former SOCBs will begin to refuse to lend for reasons other than pure credit evaluation. Moreover, listed companies and securities firms should become owned by diverse investors and approach the capital market on an objective market basis. Without breaking the present monopoly and curing the current system dysfunctions, China's financial system would be worsened by the immediate bet on either the FHC or the universal bank model. First, short term profits might reduce the incentives and retard the process of fundamental restructuring. Second, conflicts of interest would become uncontrollable because they are inherent and self-intensified. Third, if the banks bring their traditional mind-set into the capital

⁷⁰ S. Kawai & K. Muraoka, *Banking Regulation in Japan and the Treatment of Foreign Banks*, in the Michael Gruson & Ralph Reisner (eds), *Regulation of Foreign Banks: United States and International*, Chapter 18, Fourth Edition, Michie (2003).

markets, it is not hard to imagine how the capital markets will perform. In some sense, the form is merely a secondary issue.

In short, China is unlikely to adopt the universal bank model. Promising as it is, the FHC model presents legitimate doubts as well. A cautious and evolutionary approach to change should therefore be expected. Through conglomerate experiments such as Everbright, CITIC, and Huijin, the FHC model has to adapt and perfect itself gradually to the specific circumstances of China. The Chinese should overcome their universal anxiety for change, namely we have to do something, although it is far from clear what should be done and how to do it. Furthermore, a real restructuring of the SOCBs seems more meaningful and crucial. After all, bigger is not necessarily better and old wine in a new bottle doesn't taste different.