

KURZE BEITRÄGE

The Emerging Chinese Financial Conglomerates – Development and Doubt

GUO Li¹

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

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.² Thanks to the market liberation, they groped to learn how to be independent and operate like "real banks".³ To provide the foundation for the development of safe, liquid and efficient commercial banks,⁴ 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."⁵

The principle of separation between banking and securities activities was also reiterated and stressed in the Securities Law enacted in China,⁶ which mandated that:

"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." (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 at 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 in Southeast Asia, the "hot money" that plagued China's stock market in the early 1990s

¹ Associate Professor, Peking University Law School, LL.D. (PKU), LL.M. (Harvard & SMU). The research benefits from China's National Natural Science Fund (70373012) and PKU-ACOM FIRC. This paper was presented at Asian Law Institute 3rd Conference in 2006, and thanks are owed to those panelists. All errors remain with me.

² Andrew Xuefeng Qian, Transforming China's Traditional Banking System under the New National Banking Laws, 25 Ge. J. Int'l & Comp. L. 479 (1996), p. 481.

³ Id., p. 488.

⁴ Art. 4 Commercial Bank Law.

⁵ The State Council or the Central Bank through authorization set a timetable for those banks to phase out from securities business.

⁶ The law was passed on Dec. 29, 1998 and took effect on July 1, 1999.

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 the 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.⁷ Faced with deposits in excess of loans, commercial banks had a strong incentive to divert some funds into speculative outlets and reap more gains.⁸ 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,⁹ which were described as the "the only financial institutions with muscle".¹⁰ 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 let China choose in 1995 to separate commercial banking from non-banking activities, either directly or through TICs under their purview.

Things changed as time went on, and so did policy and law. After Japan and the US had successively pulled down their Glass-Steagall walls, which had imposed a strict separation between commercial banking and securities activities, proposals were poured in for China to reconsider its position, revise or repeal the related provisions. On December 27, 2003, the Standing Committee of China's National People's Congress passed thirty-seven amendments to Commercial Bank Law,¹¹ 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 per-

mitted 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.*" (Art. 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." (Art. 81)¹²

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.¹³ 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.

II. Universal Bank Model and Concerns Therewith

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."¹⁴ Acclaiming such banks as the "backbone of the rapid and successful German industrial-

⁷ Solomon M. Karmel, *Securities Markets and China's International Economic Integration*, 49 J. Int'l Affairs 525 (1996), p. 526.

⁸ Deposit Figures Highlights Progress, South China Morning Post, Sept. 14, 1995, p. 6.

⁹ 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).

¹⁰ Dede Nickerson, *Business*, South China Morning Post, May 15, 1995, p. 4.

¹¹ All amendments took effect on February 1, 2004.

¹² Those amendments took effect on January 1, 2006.

¹³ LU Xue, Report: ZHOU Zhengqing Talks on the Forthcoming Revision of Securities Law, http://www.fsi.com.cn/celeb300/visited303/303_0312/303_03123001.htm (visited March 16th, 2006). 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.

ization of the late nineteenth century",¹⁵ William L. Horton, Jr. identified four specific characteristics of the German banking system which contributed to its successful development:¹⁶ (1) close ties to industry;¹⁷ (2) independent decision making; (3) competent central bank and active regulatory support; (4) specialization of functions.

The EU Second Banking Directive (SBD) in 1989 provided¹⁸ that 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.¹⁹ To create a "level playing field", the SBD embraced three principles:²⁰ (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;²¹ (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 the same activities in any other member state under the single banking license, without need to get permission in the host country;²² 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.²³ 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.²⁴

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.²⁵ Thus, all other EU countries had a strong incentive to move towards the least restrictive German universal bank model,²⁶ which actually resulted in a competitive deregulation of the financial services in the EU financial services industry.²⁷

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.²⁸ 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.²⁹ Third, the EU views the more flexible universal banks as a powerful means to compete in the global financial marketplace.³⁰ Some academic research also showed that shares of universal banks embody substantial franchise value, which serves to inhibit extraordinary risk-taking.³¹

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.³² In April 2001, the European Commission proposed a Directive to deal with financial conglomerates, which was then agreed by the Council in May 2002.³³ Among other things, this Directive seeks to ensure 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.³⁴ Like the age-old question of whether the chicken or the egg comes first, the relationship between uncompetitive securities markets and a universal bank runs in such a self-reinforcing cycle,³⁵ which

¹⁴ William L. Horton, Jr., *The Perils of Universal Banking in Central and Eastern Europe*, 35 Va. J. Int'l L. 683 (1995), p. 684.

¹⁵ Id., p. 685.

¹⁶ Id., p. 692.

¹⁷ 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.

¹⁸ 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.

¹⁹ Joseph J. Norton/Christopher D. Olive, *The Ongoing Process of International Bank Regulatory and Supervisory Convergence: A New Regulatory-Market "Partnership"*, 16 Va. J. Int'l L. 227 (1997), p. 252.

²⁰ George S. Zavras, *Banking Integration and 1992: Legal Issues and Policy Implications*, 31 Harv. Int'l L. J. 463 (1990), p. 482.

²¹ Alfred Lewis/Gioia Pescetto, *EU and US Banking in the 1990s*, London 1996, pp. 12-13.

²² Id.

²³ Id.

²⁴ Norton/Olive (supra note 19), p. 253.

²⁵ Lewis/Pescetto (supra note 21).

²⁶ Zavras (supra note 20), p. 483.

²⁷ Lewis/Pescetto (supra note 21), p. 13.

²⁸ Zavras (supra note 20), p. 481.

²⁹ Id.

³⁰ Id., p. 482.

³¹ Rebecca S. Demsetz/Marc R. Seidenberg/Philip E. Strahan, *Banks with Something to Lose: The Disciplinary Role of Franchise Value*, 2 (2, October) Federal Reserve Bank of New York Economic Policy Review (1996), pp. 1-4.

³² 92/30/EEC (April 28, 1992).

³³ John F. Mogg, *Regulating Financial Services in Europe: A New Approach*, 26 Fordham J. Int'l Law 58 (2002).

supports China to adopt that 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.³⁶ Particularly in the above four characteristics pinpointed by William L. Horton, Jr., "ties to industry"³⁷ 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.³⁸ Notwithstanding legislative provisions emphasizing the independence of banks,³⁹ China's banks lack the autonomy and capacity of their German peers.

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.⁴⁰ Both People's Bank of China as central bank and China's Banking Regulatory Commission as 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.

III. Financial Holding Company Model and Concerns Therewith

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 did emerge in China, the Everbright Group for instance, which has two banks, two securities firms and one life insurance business in cooperation with a Canadian insurance company. Other cases include the China International Trust and Investment Corporation Group (CITIC Group), the Ping An Insurance Group, 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.

With the Glass-Steagall Act passed in 1933, banking, securities and insurance in the US were for decades carefully segregated with separate regulation.⁴¹ 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) 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 (BHCA) 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 Federal Reserve 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.

³⁴ *Gerhard Wegen*, Colloquium: Transnational Financial Services – Current Challenges for an Integrated Europe, 60 *Fordham L. Rev.* 91 (1992), p. 104. The 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.

³⁵ *Amy Chunyan Wu*, PRC's Commercial Banking System: Is Universal Banking a Better Model?, 37 *Colum. J. Transnat'l L.* 623 (1999), p. 634.

³⁶ *Haiqun Yang*, *Banking and Financial Control in Reforming Planned Economies*, Basingstoke 1996, p. 76.

³⁷ Although legally Article 43 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 up to now to some extent and in some form, such interconnections still remain.

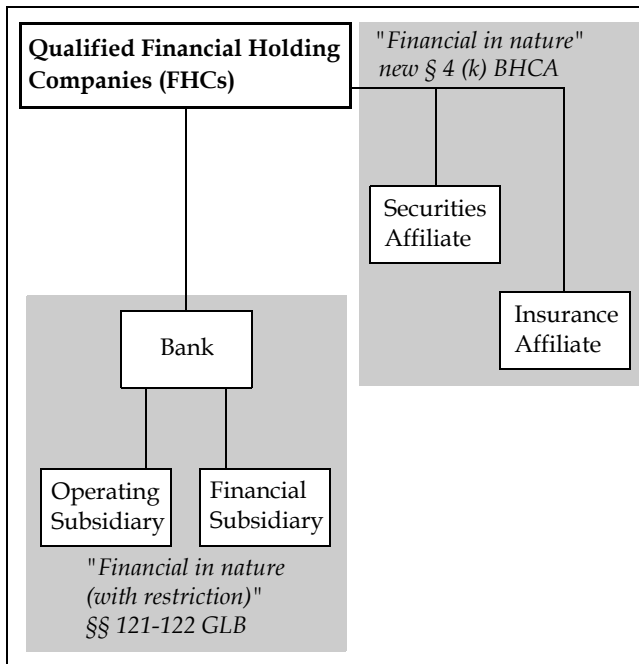
³⁸ *Horton, Jr.* (supra note 14), p. 696.

³⁹ For example, Art. 4 Commercial Bank Law.

⁴⁰ *Horton, Jr.* (supra note 14), p. 700.

⁴¹ The Glass-Steagall Act was actually the popular name for Sections 16, 20, 21 and 32 of the Bank Act of 1933.

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 it, both commercial and investment bank stocks rose.⁴² Studies also showed that the market responded most favorably to the shares of Bank Holding Companies (BHCs) that had already engaged in some securities businesses (those with Section 20 subsidiaries allowing limited investment banking activities).⁴³

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 stay suspicious that safeguards designed in the GLB are not sufficient to eliminate hazards such as conflicts of interest, still less to resolve such emerging problems as undue encroachment upon consumer privacy.⁴⁴ 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.⁴⁵ As once expressed by the US Supreme Court in *Investment Company Institute v. Camp*,⁴⁶ 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.⁴⁷

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), as least where a bank "coerces" a customer to buy the tied product.⁴⁸ Moreover, such coercion could not exist unless the bank had more leverage in the lending market, which is unlikely in the current situation.

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; rather FHCs have mainly been used to free holding companies from restrictions placed on existing securities affiliates, such as limits on underwriting and dealing to 25 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.

When our focus moves back, should and could China continue to follow the US's suit and embrace readily the FHC model? Further concerns deserve attention. First, some inherent problems of FHCs have to be carefully reckoned, for instance, those relating to capital adequacy, corporate governance and risk control. (1) Capital adequacy: A poorly

⁴² Cara S. Lown/Carol L. Osler/Philip E. Strahan/Amir Sufi, The Changing Landscape of the Financial Service Industry: What Lies Ahead?, 6 (4, October) Federal Reserve Bank of New York Economic Policy Review (2000), pp. 39-55.

⁴³ YU Li, On the Wealth and Risk Effects of the Glass-Steagall Overhaul: Evidence from the Stock Market, New York University Working Paper (2001).

⁴⁴ House Commerce Wrangle with Privacy in Approving Financial Services Measure, Banking Policy Report Vol. 72, No. 24.

⁴⁵ Joan M. LeGraw/Stacey L. Davidson, Glass-Steagall and the "Subtle Hazards" of Judicial Activism, 24 New Eng. L. Rev. 225 (1989), pp. 225-228.

⁴⁶ 401 U. S. 617 (1971).

⁴⁷ Ibid., pp. 630-637.

⁴⁸ Federal Reserve Board, Proposed Interpretation of Section 106 of the Bank Holding Company Act, August 25, 2003.

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.⁴⁹

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.⁵⁰ 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 industry,⁵¹ by 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 the like sophisticated investment players. Before the 1995 separation, China's largest securities firms were supported by state-owned

commercial banks.⁵² 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.⁵³ 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,⁵⁴ and many other countries.⁵⁵ 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 went listed in Hong Kong in 2005. The year of 2006 first witnessed the triumph of Bank of China (BOC) in its oversubscribed public offer and listing consecutively in Hong Kong 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 divestiture by the State, they 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 loan. 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.⁵⁶ At the same time, empirical research has

⁴⁹ John Boyd/Stalney L. Graham/R. Shawn Hewitt, Bank Holding Company Mergers with Non-bank Financial Firms: Effects on the Risk of Failure, 17 (1) Journal of Financial Economics (1993), pp. 43-63.

⁵⁰ Ingo Walter, Strategies in Financial Services, the Shareholders, and the System: Is Bigger and Broader Better?, in: Robert E. Litan/Richard Herring (eds.), *Brookings-Wharton Papers on Financial Services*, Washington D.C. 2003, p. 21.

⁵¹ See the preamble (purpose) of this Act.

⁵² Nickerson (supra note 10).

⁵³ Even though legally speaking Art. 4 of the Commercial Banking Law has specially made banks responsible for their profits and losses.

⁵⁴ Maureen O'Hara/Wayne Shaw, Deposit Insurance and Wealth Effects: The Value of Being "Too Big to Fail", 45(5) Journal of Finance (1990), p. 1587.

⁵⁵ For example, *US General Accounting Office*, Deposit Insurance: Overview of Six Foreign Systems, GAO/NSIAD-91-104 (1991).

⁵⁶ For example, Allan N. Berger/William Hunter/Stephen Timme, The Efficiency of Financial Institutions: A Review and Preview of Research Past, Present and Future, 17 (April) Journal of Banking and Finance (1993), pp. 221-249.

failed to find significant cost economies of scope in financial industries.⁵⁷

Third, potential regulatory restructuring presents another pragmatic problem in China. Back in 1992, the central bank, People's Bank of China (PBOC), 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 in 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 the Federal Reserve model)? Or should they undergo another round of merger and functional re-streamline (if taking the Financial Supervisory Authority [FSA] model)?⁵⁸

Resolving regulatory conflicts might be knottier than first appears, when activities and transactions begin to straddle formerly distinct jurisdictions. On the one hand, historically and philosophically a centralized approach seems better suited to 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 jealously kept to the states or separate agencies. But, will a 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 goes that "a long time of integration leads to separation, whereas a long time of separation leads to integration."⁵⁹ For many people, a uniform FSA rather 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, and consensus is very difficult to be reached soon.

Fourthly, two categories of latest development increased concerns regarding the FHC and its hybrid. Within governmental experiments, China's central government set up the State Administration of Foreign Exchange (SAFE) Investments, which modeled Temasek in Singapore and now controlled banks such as CCB and BOC as well as some securities firms. At local levels, similar or even 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 state-owned enterprises (SOEs) and restructuring local financial institutions. In 2006, the company has also begun to make strategic investments on behalf of the Chongqing government.⁶⁰ Some doubt that such action in fact blurs the line that should be drawn between financial and industrial sectors and represents a possible retrogradation towards the all-around and inefficient governmental entity.

Private companies also probed the FHC style with the will to maximize their interest, while often fell within the abyss of disgrace and crime, among which the most notorious example is Delong Group. Initially incorporated in Xinjiang Uygur Autonomous Region and then headquartered in Shanghai, Delong's story started with three siblings, the ambitious grass-root entrepreneur who 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

⁵⁷ For example, *Chris Stefanadis*, Specialist Securities Firms in the Gramm-Leach-Bliley Era, Federal Reserve Bank of New York Working Paper (2002).

⁵⁸ In May 1997, the United Kingdom announced a total restructuring plan of its regulatory regime for financial services, including to combine banking supervision and securities regulation under a new agency called Financial Supervisory Authority (FSA), which plan was implemented in 1998. Japan, Taiwan and others took similar action.

⁵⁹ 合久必分，分久必合。

⁶⁰ *LI Zhigang, et al*, Report: Chongqing Builds Financial Holding Firm, 156 *Caijing Magazine* (2006), pp. 73-81.

acquisition and eventually became the de-facto private financial conglomerate.⁶¹

Subsequent investigation discovered that Delong proved to be a huge fund black hole and accumulated more than US\$ 2 billion unpayable losses. When things went sour and its controlled stock prices nose-dived in 2004, RMB 20 billion Yuan in market value evaporated within 10 days. The head of Delong – Mr. TANG Wanxin, stood trial on April 29, 2006 for charges of illegal public deposit taking and manipulating stock prices, and an 8-year imprisonment penalty plus a RMB 400,000 Yuan personal criminal fine was finally inflicted. As for the Delong Group, it was imposed with a US\$ 1.3 billion company fine, which was deemed as most likely uncollectable by analysts. The Delong incident evidently demonstrated the devastation by the FHC off the track, as well as the current supervision failure.

IV. 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 long run. Whatever conglomerate model adopted, the unified and highly centralized control of the financial system by the State or its agents has to be changed. China has paid too much for it. In the planned economy era and for many years thereafter, SOEs were the major 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, the SOCBs mainly considered 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. The non-performing loans of the SOCBs were thus accumulated up.

We hope that through incorporation and listing the former SOCBs could refuse to lend for reasons other than pure credit evaluation. Moreover, listed companies and securities firms should become owned by diversified investors and approach the capital market on an objective market basis. With-

out breaking the immanent monopoly and curing the 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 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 too. A cautious and evolutionary approach to change should therefore be expected. Through conglomerate experiments such as Everbright, CITIC and SAFE Investments, 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. 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 the old wine in a new bottle does little good.

⁶¹ LING Huawei, *et al*, Report: Finale in Sight for Delong Sage, 150 Caijing Magazine (2006), pp. 38-63.