REFORMS AND REGULATIONS IN CHINESE BANKS – DEVELOPMENTS AND RECOMMENDATIONS FOR IMPROVED SUPERVISION

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ABSTRACT: *It is a well-known fact that the P.R.C. has been undergoing tremendous economic growth and commercial development. This has impacts not only on the Chinese economy but also on the world economy. This development is not possible without the participation on the nation's banks. Therefore, in this paper, I first introduce the banking system in China. Then, I explore the developments in reforms and regulations within the Banks in China. I do so through analyzing 3 key areas of reforms: legal reforms, reforms in corporate governance, and structural reforms. Then, I discuss current trends in banking and finally give my recommendations for increased enforcement and increased competitive of China's banks.*

KEYWORDS: reforms, regulations, Chinese banks, developments, improved supervision

INTRODUCTION

Banks, as we have seen in numerous financial crises throughout the world, are highly effectual on other sectors of the economy. The well-being of banks impacts social welfare of the people, jobs, real estate, trade, etc. Therefore, it is important for governments to regulate banks in order to reduce systematic risks. For an economic powerhouse such as China, it is even more crucial that its banks are properly regulated and that there is no misuse of the banking authority. It is important to avoid possible misuse and abuse of resources, and allow the credit system to function properly. In this paper, I discuss the background and recent reforms in Chinese banks. I then discuss recent trends and give recommendations.

Historical Background

From 1978 onwards marked an era of opening up of China's commerce and trade to the rest of the world. This opening up included increase of banking institutions and increased financial activities domestically and with foreign partners. While the increase of banks means additional options in financial services, there is also a rising need for regulation. Furthermore, in the subsequent years leading up to today, there were further developments in banks in China. In light of these changes, it is important to regulate and ensure order in this very important industry that has wide ranging effects on the economy.

Reforms

The Asian financial crisis of 1997-1998 resulted in bank collapses in various nations and a sense of endangerment to the other banks.[1] Because of this, the need to properly regulate banks to protect them from these dangers became apparent. Another motive for reform was China's entry into the World Trade Organization n 2001.[2]As a part of its WTO entry in 2001, China agreed to open its banking to foreign competition. This means a need to reform China's own banks in order to compete with foreign banks. The following section discusses the three main areas of reforms: legal, corporate governance, and structural. While reforming the entire banking industry in China will take substantial efforts, action has been taken and results are evident. This section aims to discuss the current and ongoing reforms in the Chinese banks.

Areas: Legal Reform

A series of laws and legislation have been promulgated to regulate and reform the banks in order to reduce banking risks and protect the economy and consumers. One of the earlier laws is the Central Bank Law in 1995, which made People's Bank of China the sole agency that regulates Chinese banking. [3] The Law of the People's Republic of China on Commercial Banks was adopted in 1995.[4] The provisions to note for purposes of this paper are in Chapter I: General Provisions, and Chapter VI: Supervision and control.[5] The other chapters, respectively, concern the establishment of commercial banks, protecting depositors, rules of loans, accounting, control, legal responsibility, and supplements.[6]

Article 1 introduces the legislative intent to the law, that it shall "protect the lawful rights and interests of commercial banks, depositors, and other clients…"[7] It also intends to "raise of quality of credit assets," "strengthen supervision and control," and ensure "stable and sound operation,"[8] Other relevant provisions are as follows:
"Article 2: For the purposes of this Law, the term "commercial banks" means enterprise legal persons that are established in conformity with this Law and the Company Law of the People's Republic of China and that take in deposits from the general public, grant loans, handle settlements, etc.
Article 3: Commercial banks may engage in some or all of the following business operations:
(1) taking in deposits from the general public;

[1] Stephen Thomas and Chen Ji, *Banking on Reform*, China Business Rev. Vol. 33(3), at 20-26 (2006).
[2] *Id.*
[3] YK Mo, A Review of Recent Banking Reforms in China, *BIS Policy Papers* (1999). Available at: https://www.bis.org/publ/plcy07d.pdf.
[4] Law of the People's Republic of China on Commercial Banks (promulgated by Order No.47 of the President on May 10, 1995; amended Dec. 27, 2003*), translated at* http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383716.htm.
[5] *Id.*
[6] *Id.*
[7] *Id.*, art. 1.
[8] *Id.*

(2) granting short-term, medium-term and long-term loans;
(3) handling domestic and foreign settlements;
(4) handling the acceptance and discounting of negotiable instruments;
(5) issuing financial bonds;
(6) acting as an agent for the issue, honoring and underwriting of government bonds;
(7) buying and selling government bonds and financial bonds;
(8) engaging in interbank lending;
(9) buying and selling foreign exchange and acting as an agent for the purchase and sale of foreign exchange;
(10) engaging in the business of bank cards;
(11) providing letter of credit services and guaranty;
(12) acting as an agent for the receipt and payment of money and acting as an insurance agent;
(13) providing safe deposit box services; and
(14) other business operations as approved by the banking regulatory authority under the State Council.
The scope of business shall be specified in the articles of association of the commercial bank, and submitted to the banking regulatory authority under the State Council for approval.
Upon approval of the People's Bank of China, commercial banks may engage in the business of the settlement and sale of foreign exchange."[9]

The law requires that an article of association be provided that includes the scope of business of the bank. This is a measure to ensure that banks have framework of their activities, rather than engaging in financial activities freely. From these articles, we see that the law outlines the scope of operation for commercial banks in China, notably giving banks permission to take deposit from the public and to issue bonds. Since banks take deposit from the public, thus affecting the people's wellbeing, it is important that legislation regulate banks and prohibit reckless or wrongful conduct in banks.

Reforms in Corporate Governance

In additional to the legislative reforms discussed above, Chinese banks are undergoing or have undergone reforms within their own governance boards. For example, CCB, one of the big four banks in China, has reduced the size of its Board of Directors from 60 to 15.[10] Furthermore, it has set up a supervisory board which oversees accounting, auditing, internal supervision and controls.11 This is helpful because supervisory boards can serve as an additional source of enforcement, ensuring that the bank complies with law, and ensures that they best interest of the bank are served.

[9] *Id*., art. 2-3.
[10] Thomas and Ji, *supra*.
[11] *Id.*

Reforms like the ones in CCB are propelled by legislation such as the "Guidelines on Corporate Governance of Commercial Banks."[12] According to Article 7, "sound" corporate governance of a commercial bank include the following:

1. "a sound organizational structure;
2. a clear boundary of responsibility;
3. objective development strategies and value principles and a full awareness of social responsibility;
4. effective risk management and internal controls;
5. rational incentive and restraint mechanisms; and
6. an adequate and effective information disclosure system."13

Chapter II of the Guidance outlines the sound organizational structure that should in place for corporate governance. For example, Article 9 adds the requirement the duty of "good faith" to shareholders. This also means that principle shareholders (who directly, indirectly, or jointly holds or controls more than 5% of the shares or voting rights of a commercial bank or has a significant influence on the decision-making of the commercial bank) have to disclose information in a timely manner. 14 These requirements add a sense of responsibility and duty to the major shareholders and decision makers of a company. Furthermore, Article 10 prohibits shareholders from "improper benefits."[15]

In addition to general principles on sound corporate governance, this legislation also has specific requirements for Board of Directors at banks:"The board of directors of a commercial bank shall be responsible to the shareholders' meeting, and assume the ultimate responsibility for the operation and management of the commercial bank. In addition to performing its functions in accordance with the Company Law and other laws and regulations as well as the bylaws of the commercial bank, the board of directors shall also pay particular attention to the following:

(1) Formulating the business development strategies of the commercial bank and overseeing the implementation thereof…
(4) Regularly assessing and improving the corporate governance of the commercial bank.
(5) Being responsible for the information disclosure of the commercial bank and assuming the ultimate responsibility for the authenticity, accuracy, integrity and timeliness of the accounting and financial reports of the commercial bank."[16]

As we see from this article, the Board needs to regularly oversee the corporate governance of the bank, which is defined in Article 7. This article is helpful because it delegates the duty to oversee the corporate governance to individuals in particular --the Board.

[12] Notice of the China Banking Regulatory Commission on Issuing the Guidelines on the Corporate Governance of Commercial Banks (issued Jul. 19, 2013 by China Banking Reg. Comm'n.), *translated at* http://www.lawinfochina.com/display.aspx?lib=law&id=14767&CGid= .
[13] *Id*., art. 7.
[14] *Id*., art. 9.
[15] *Id.,* art. 10.
[16] *Id*., art. 19.

Otherwise, the officers and employees in the bank may be confused as to who has the duty. This legislation clearly assigns the duty to the Board members. The Board should also set plans for risk management, and the operational risks of the bank:

"The board of directors of a commercial bank shall, according to the actual condition of the commercial bank, set up separate or combined special committees, such as strategy committee, audit committee, risk management committee, affiliated transaction control committee, nomination committee, and compensation committee…

The audit committee is primarily responsible for inspecting the risk and compliance status, accounting policies, financial reporting procedures, and financial condition of the commercial bank; and responsible for conducting the annual auditing work of the commercial bank, advising the commercial bank on employment or replacement of an external audit institution, preparing a report on its judgment regarding the authenticity, accuracy, integrity and timeliness of information in the audited financial reports, and submitting such reports to the board of directors for deliberation."[17]

This article 22 further specifies the duties of the Board in order to achieve the overarching goal of sound corporate governance. Specifically, it names auditing as an important means to ensure that the banks are functioning properly. This is an important provision because within banks, since there is such a high volume of monetary transactions, it is crucial to ensure that there are no internal wrongdoings by staff or by officers. Therefore, specific measures, such as requiring auditing, are helpful in avoiding mishaps.

Structural Reforms

There are also structural reforms over the past years. This includes streamlining operations within banks through cutting unnecessary staff.[18] This promotes more efficiency in operations, where job positions not crucial to the operation of the bank are cut. Streamlining operations also includes adding new lines of business, such as providing home mortgagees, auto and consumer loans, etc.[19]

.According to the World Economic Forum, an international organization in Switzerland that promotes public-private cooperation, China has undertaken some structural reforms.[20] According to Haruhiko Kuroda, governor of the Bank of Japan, "China is making huge structural reforms while continuing to grow at 7.5%." [21].

These reforms include freeing up capital flows that promotes trade and commerce.[22] Changes such as this allow capital and investments to more easily change hands, which

[17] *Id*., art. 22.
[18] Thomas and Ji, *supra.*
[19] *Id.*
[20] David Ashworth, *What investors should know about the World Economic Forum*, MARKET REALIST (Feb. 2, 2015), http://marketrealist.com/2015/02/investors-know-world-economic-forum/ (last visited Apr. 5, 2016).
[21] *Id*.
[22] *Id.*

incentivize investment and trade of this capital. This freeing up of capital, combined with streamlining operation within banks, are both favorable moves for China's banks. These change help the banks to be more competitive, especially in a global market, in terms of convenience of trading and efficiency in operations.

Compliance with International Standards: Basel III

The Basel Committee is an international organization that sets regulatory standards for banks. In order to ensure that international standards for banking supervision are implemented, the Basel Committee established the Regulatory Consistency Assessment Programme (RCAP) in order to assessment implementation of its standards.[23]

Capital Rules

China, as one of the leading economies of the world, is committed to these international standards. In fact, in 2012, the China Banking Regulatory Commission established Capital Rules in order to ensure timely and orderly implementation of Basel standards.[24]

These Capital Rules for Commercial Banks was adopted at the 115th chairman meeting of China Banking Regulatory Commission.[25] These rules apply to commercial banks incorporated in the PRC.[26] It has the following stipulations:

- Regarding capital: "capital of a commercial bank shall be adequate to help the bank with risks."[27] Even though this article is general, it sets the guidelines for capital of banks.
- Regarding capital adequacy ratio: " shall be calculated on the consolidated and solo basis."[28]
- Regarding risk management: a comprehensive risk management framework shall be in place.[29]

Article 23 stipulates that a commercial bank is subject to the following requirements:

1. Common Equity Tier 1 capital adequacy ratio of no less than 5%;
2. Tier 1 capital adequacy ratio of no less than 6%;
3. Capital adequacy ratio of no less than 8%.[30]

Specifically, common equity Tier 1 capital consists of the sum of the following:

- Paid in capital or common shares;

[23] BASEL COMMITTEE ON BANKING SUPERVISION, Sep. 2013. Accessed at: http://www.bis.org/bcbs/implementation/l2_cn.pdf.
[24] *Id.*
[25] Capital Rules for Commercial Banks (Provisional), (promulgated by the CBRC for implementation effective January 1, 2013). Available at: http://www.cbrc.gov.cn/EngdocView.do?docID=86EC2D338BB24111B3AC5D7C5C4F1B28 .
[26] *Id.,* art 2.
[27] *Id.,* art 3.
[28] *Id*. art. 6
[29] *Id*., art. 7.
[30] *Id*., art 23.

- Capital reserve, surplus reserve, and general reserve;
- Undistributed profits, and
- Minority interests that meet criteria.[31]

Since the common equity Tier 1 includes many forms of capital, this provision ensures that certain amounts of capital are reserved. It is good to have such a requirement because during the operation of banks, there are needs for capital. In order to avoid a crisis in the event of a bank run, it is necessary that some capital be constantly be reserved.

RCAP Assessment Findings

The RCAP Assessment, mentioned earlier in this section, found that in regards to key areas, Chinese banks are generally consistent with the international standards set in Basel III.[32] The overall grade of implementation of the Basel capital framework was "c", for compliant.[33] Specifically, for capital requirements, generally the grade of "compliant" was given, in the areas of: credit risk, market risk, and operational risk. This is a favorable finding because it demonstrates that policies set by the capital rules are effective, or at least positive for purposes of promoting capital requirement compliance, in order to reduce market and operational risks.

Recent Developments:

In light of these legal and internal reforms, there are some recent trends or events in Chinese banking that are worth noting:

Loosening Credit and Increased Lending

In January 2014, Chinese banks extended a total of 1.3 trillion yuan in loans in an attempt to avoid a slowing economy. 34 It is important to know that while the CBRC allows credit related activity; in general credit lending should be regulated. As a well-known phenomenon, a cause of the 2008 U.S. financial crisis was over extension of loans and trading of subprime mortgages by American financial institutions. To avoid such instance, in extending credit, Chinese banks should be aware of the potential risks in over-lending in order to avoid financial problems.

Increased Private Shareholding

Some State-owned enterprises, other than banking, have introduced policies that allow more non-state owned enterprises to become stakeholders. [35] The Bank of

[31] *Id*., art 29.
[32] Regulatory Consistency Assessment Programme (RCAP); Assessment of Basel III regulations – China, *supra*.
[33] *Id*. at 12.
[34] Oliver B. Barron, *China Bank Loans: Reform of Bust*, FORBES MAGAZINE, Feb. 17, 2014.
[35] Shu Zhang and Pete Sweeney, *China Steps up Banking Reforms, Lets Broader Ownership at Bank of Communications*, THOMSON REUTERS, Jun. 17 2015.

Communications, one of the largest banks in China, had been allowed to engage in more private shareholding.[36] This attempts to boost the bank's growth through allowing more private investors to contribute capital into state-owned banks.[37] Introducing private investors and shareholders would in theory allow more drive to make profits since private shareholders strive for profit, unlike SOEs that may have to balance their interests with state interests. Private shareholders, in pursuing profits, may help reduce unnecessary costs such as operational costs, unneeded staff, etc.

RECOMMENDATIONS

Penalty for Violation

While legislation require sound risk management and have capital requirements, explicitly stating the penalties for violations may deter violation. Although regulations such as the Capital Rules state that banks shall have sound risk management framework in place, it does not specifically say what the punishment is for not having a framework. Since it is not specified, some banks for management may accidentally or intentionally violate the rules because there does not seem to be any punishment. Therefore, the regulations would probably have more enforcement power if the penalties are written out and publicized.

Increased Market Disclosure

According to the RCAP Assessment mentioned prior, although Chinese banks are compliant in most categories, in Market Discipline – Disclosure, it is only "largely compliant", not fully compliant.[38] The Assessment found that detailed disclosure of information regarding credit quality and securitization was missing.[39] Specifically, regulation was not explicit regarding breakdown of impaired loans and loan loss allowances by industry.[40] Therefore, I recommend that more specific regulation be implemented regarding disclosure. This is important because proper disclosure allows regulatory authorities and consumers and potential investors know more about the market. It helps others see if there are any potential risks or concerns.

Additional Investor Knowledge

As we saw in the earlier discussion, there has been increased private shareholders at Chinese banks. To further incentivize investors to invest in banks, perhaps additional distribution of information may help. This may include making financial statements and financial information easily accessible to potential investors and depositors. For example, banks can mail out financial information to key investors and consumers to their home

[36] *Id*.
[37] *Id*.
[38] Regulatory Consistency Assessment Programme (RCAP); Assessment of Basel III regulations – China, *supra*.
[39] *Id*. at 17-18.
[40] *Id*.

addresses every quarter. This is a meaningful disclosure method but may also instill confidence in potential consumers and investors. This may grow the clientele of the banks.

CONCLUSION

The tremendous economic developments in China have cast its impact on all sectors of society, including banking. As the nation's banks face increased competition from foreign banks and face internal pressure to function within a socialist market economy, there is increased need for reform and making changes in order to adapt. In this paper, I first introduced the banking system in China. Then, I discussed several types of reform that have been occurring within China's banks.

I recommend 3 key steps in order to better enforce the reforms and help the banks better assimilate to the global market. This includes explicit penalties for violation, carried out through amendments to the banking legislations. Specifying the penalties should deter wrongdoings and deter bad behavior. Another recommendation is to provide enhanced disclosure. Finally, another recommendation is to increase the knowledge flow to potential investors and consumers so that they feel confident and trustful of banks. Given the size and scope of Chinese banks, reforms may take time and continued efforts to implement, though steps have certainly been taken towards the proper direction.

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