Junbo Xiang: Improve the legal system to prevent financial risks

Speech by Mr Junbo Xiang, Deputy Governor of the People's Bank of China, at the "2005 High-level Forum of China's Financial Reform", Shanghai, 26 April 2005.

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Ladies and Gentlemen:

It's a pleasure to attend this high-level forum of China's financial reform, sponsored by the Financial Research Institute, Development Research Center of the State Council. In my view, the theme of this forum, "Financial Innovation and Risk Prevention", is of great significance. Innovation is the inexhaustible impetus for the development of financial sector. The rise and decline of financial development in the 20th century can be viewed as a history of innovations one after another. In 1950s, the institutional investor sprang up with the establishment of modern pension funds. In 1960s, credit card appeared. In 1970s, Eurodollar and Eurobond came into being. And since 1980s, in a new round of financial liberalization, various financial derivatives and cross-financial sector products were introduced in the market. Of course, due to the uncertainty of innovations, while the innovations on financial system, institutions, market, products and service boosting the growth of financial sector and profits of financial institutions, new financial risks also emerged. China is also confronted with such problems. Therefore, how to deal with financial innovation and risk prevention to keep a balance between them poses a big challenge for supervisory authorities and financial institutions.

Financial legal system not only provides regulation for financial institutions, financial business participants and their legal relationship, but also improves the self-discipline of financial supervisors. The main target of financial legislation is to adjust the legal relationship among financial supervisors, institutions and customers, protect customers' legitimate rights, and strengthen the supervision on those areas where market plays a leading role in coordinating financial supervision and market self-discipline. Where there is market, there is risk, which is also the same for the financial sector. Thus, the purpose of financial legislation is not to wipe out all risks, but to control it in a certain scale that can be handled by the supervisors and absorbed by the financial institutions. Viewing from this aspect, the establishment and enforcement of financial legal system are indispensable for preventing, controlling and dissolving financial risks. On today's occasion, I would like to share with you my observations about the prevention of financial risks in China in the broad context of financial innovation from the aspect of financial legislation.

I. Current status of financial risks in China

Financial risk refers to the possibility that a financial institution suffers from a loss of funds, property or reputation due to changes in macroeconomic policy environment, market situation, exchange rate or mismanagement. And there are various kinds of risks, such as operational risk, institutional risk, macro-risk, micro-risk, etc. According to the Basel Core Principles on Effective Banking Supervision, the financial risks can be classified into eight categories, including credit risk, market risk, operational risk, liquidity risk, legal risk, etc. Judged by each of these categories, China's financial risks have broadly reduced in recent years. However, potential risks still exist in the financial sector. In my opinion, there are obviously three kinds of risks in China's financial system.

First, credit risk remains the major risk in China's financial industry. Loan and investment are the main business of financial institutions, which requires financial institutions to make appropriate assessment on the credit status of the lender and receiver of investment. However, due to the information asymmetry, their assessment cannot always be correct, and the credit standing of the lender or the receiver of investment may decline due to various factors. Therefore, a major risk financial institutions facing is the lender's default risk, i.e., credit risk. During business operation, if financial institutions fail to timely identify the problematic financial asset, set up special loan loss provisions to write off bad loans, or stop accruing relevant interests, there will be serious problems ahead.

According to the balance sheet, asset quality of China's banking institutions has been enhanced in recent years, with the absolute amount and ratio of non-performing loans declining, which could be attributed to the supervisors strengthening regulation and the financial institutions deepening reform to improve internal management. But we have to be mindful of the fact that the decline of non-performing loans is also partly a result of economic expansion, in which bank loans increased dramatically. For

example, in 2003 and 2004, new loans in all financial institutions amounted to RMB2740 billion and 2260 billion yuan respectively. Besides, compared with the international banking standard, China's major commercial banks still have a relatively high NPL ratio of 13.2% in 2004, and the CAR of most commercial banks have not met the legal requirement of 8%.

While assessing the credit risks of the financial institutions, one of the important points is the large increase of loans in the real estate sector. The development of China's real estate sector is closely related to the housing reform, which started in the end of last century and finished in recent years. Housing mortgage loans emerged as a new business after the start of housing reform. Since the real estate lending has a relatively stable income compared with traditional business, it is actively developed by banks. Therefore, it's reasonable that real estate loans increase fast. However, real estate lending in China is relatively a new business that has not been tested in economic cycle changes. It has just started a few years ago and there is no available data on the medium and long-term default ratio. Besides, the Chinese economy is in a new expansion period, and the prosperity of the economy partly covers the potential risks involved in real estate lending. The economic prosperity changes as the tide, and once the pace of the economy slows down, the default ratio of real estate lending will probably increase, so we cannot be too optimistic. In this field, we should learn from the lessons of Japanese real estate bubble. After the bubble burst, their bad loans increased dramatically and bond market was also affected, in addition to the revaluation of yen, which push the Japanese economy into a decade of recession. As a developing country, China always stresses the sustainable, steady, fast, and healthy development of economy. If we failed in this field, the economy would suffer a huge loss, even if the recession may only last for a few years.

Not only banks but also securities companies face high credit risks, with most securities companies suffering low asset quality. Recently, many of the insolvent ones have been taken over, and the Central Bank has to provide central bank lending to pay individual creditors of these companies. Thus, we cannot relax our vigilance on credit risk in the financial sector, for it remains one of the major risks in the financial industry.

Second, the frequent occurrence of operational risk is one of the outstanding characteristics in the financial industry. According to the definitions made by the Basel Committee, financial institutions face two kinds of operational risks: one refers to the losses resulted from the failure of information and technology system or other disasters; and the other refers to the losses resulted from the failure of internal control and the failure in responding promptly to various mistakes, frauds, misuse of power or various moral hazards. In terms of the exposed operational risks in recent years in the financial industry, the failure of internal control constitutes the major source of operational risks. In particular, the resulted loss mainly comes from corruption of the senior management, irregularities of the staff, and financial frauds.

Recently, many cases have been detected in the financial sector, especially in commercial banks, which to some degree could be attributed to the deepening of banks' internal reform, exposing the deeply hidden cases. Even though, it indicates that the operational risk is relatively high in China's financial sector, which is not in line with our strategic target to establish a modern financial system. The continuously exposed operational risks not only make financial institutions suffer big losses, but also impair their reputation. For example, the latest exposed major cases in financial system have negative impact on the financial industry's reputation both at home and abroad.

Third, cross-market and cross-sector financial risks become new unstable elements in China's financial industry. In recent years, with the restructuring of the financial industry and the increasing consolidation of financial business, cross-market and cross-sector financial risks becomes a new element affecting the stability of the financial system. Nowadays, such risks are shown in two aspects. First, various financial-holding companies have emerged, such as the CITIC. Such financial-holding companies provide both banking products and securities products. However, effective and consolidated supervision is lacked, leading to many potential risks, such as infringement of consumer (investor)'s interests, connected trading and the transmission of financial risks from one subsidiary to other companies or to the whole group. Second, banks, trust companies, securities firms and insurance companies are developing kinds of cross-currency, cross-financing, and cross-market products and instruments in an effort to dismantle business segregation, such as the joint entrusted loan business and wealth management business provided by banks, which involve potential risks.

Through the PBC's recent experience in preventing and dealing with systematic financial risks, we have found that cross-market financial risks are on the rise. Theses risks are more prominent in the capital operation of financial holding companies or sub-financial holding companies that were originally

industrial companies. As such companies have business in both the industrial sector and financial sector, which involves banks, securities companies, trust companies and insurance companies, their capital operation is characterized by a financing chain of "Financing—M&A—Listing—Re-M&A—Re-financing". Huge operational risks are hidden in the chain. Given that both ends are "financing", financial institutions will become the biggest victim if the chain breaks. For instance, the recent crisis with a number of associated listed companies hurt numerous stock investors, shook the stock market, and inflicted heavy losses on relevant financial institutions. The stability of the entire financial system is also threatened.

It goes without saying that financial innovation has become an effective means to seek greater prospect, return and competitiveness by financial institutions. Nonetheless, the external environment and the business model of financial institutions are undergoing sea changes, and financial-innovation-related new products and businesses could transfer risks among financial institutions. The entrusted wealth management business, which is actively promoted by banks, securities companies, trust companies and insurance companies, deserves our special attention. Despite the different names given to the business by different financial institutions and the different rules of operation, the fact that the so-called "wealth" is invested in the stock market, foreign exchange market, and inter-bank bond market suggests that this business/product is a cross-market financial product. We have learned from some recent crises in high-risk securities companies that the huge losses incurred from entrusted wealth management business played a vital part in the insolvency of such companies. As active players in the money market, securities companies will undoubtedly transfer their own risks to other market participants. We are by no means against the entrusted wealth management business, though. We are merely suggesting that the financial risks associated with cross-market financial products have surfaced.

II. The causes of China's financial risks in perspective of legal framework for the financial sector

The high risks embedded in China's financial system are the result of various problems in the national economy over a protracted period. The transition of the economic system, the change of the social environment, the rigidity of the financial system, the inadequacy of financial supervision and the defects in the legal framework for the financial sector are among the causes of the high risks in China's financial system. Scholars and government officials have done numerous studies in those regards. Here, I would like to discuss the reasons underlying these risks, especially the three major risks, in China's financial sector from the legal point of view.

As is known to all, the legal framework is in essence a tool to regulate the relationship among financial supervisors, financial institutions and investors in financial products. In addition to regulating the legal relationship, the legal framework for the financial sector has many other functions, including punishment, encouragement, inhibition and guidance. In economic terms, it could be translated into predictable interest or loss. A large number of rules and regulations for the financial sector have been formulated since 1979, when China adopted the reform and opening-up policy. Such rules as the *Law of the People's Republic of China on the People' s Bank of China*, the *Commercial Banking Law of the People's Republic of Chin,* the *Law of the People's Republic of China on Banking Regulation and Supervision,* the *Securities Law of the People's Republic of China,* and the *Insurance Law of the People's Republic of China* which regulate financial supervision, financial institutions and their behaviors, have formed the fundamental legal framework for the financial sector. The *Law on Administrative Penalty,* the *Law on Administrative Appeal,* and the *Law on Administrative License* are designed to regulate the administrative behavior of financial supervisors. In addition, the *Law on Negotiable Instruments,* the *Guarantee Law,* and the *Company Law* are designed to regulate civil and commercial relations.

However, we should be aware that the existing financial legal rules were established in the development of emerging markets and the transitional period of economy. With the deepening reform of China's financial system, the accelerating opening-up and the enhancing innovation of the financial sector, the existing legal framework can hardly satisfy the changing requirement of the financial sector. Especially, we need to make an overview of the basic legal environment that our financial sector relies on and improve the research on laws for financial innovation (including system innovation, institution innovation and product innovation). Currently, three kinds of financial risks stand high in China's financial system, which is to some degree related to the inadequacy and incompatibility of our legal rules.

First, the lack of regulations on credit reporting hindered the development of credit reporting industry and the evaluation on the credit status of the borrowers by the financial institutions. Generally speaking, credit reporting refers to the collection, evaluation and sales of market participants' credit information, and the credit information system is established to address the information asymmetry in financial transactions. With the economic activities being more and more complicated, the financial institutions increasingly rely on credit reporting department or social credit reporting agency to enhance the investigation and analysis of the credit status of borrowers. The establishment of credit information system has not been put on agenda in China until recent years. It is a task that should be strongly supported by laws since corporate and individual credit information collection involve the privacy of citizens and commercial secrets of enterprises. However, there is no relevant rules for credit reporting in the existing legal framework, and hence the credit reporting agencies can not collect and disclose information according to laws and the interests of the enterprises and individuals can hardly be safeguarded, which has hindered the healthy development of credit reporting industry. Failure of the financial institutions to timely detects irregularities in financial transactions such as duplicate frauds, repetitive mortgage with the same assets and connected guarantee, etc. may cause great asset loss.

Second, the underdeveloped enterprise insolvency law makes it difficult for financial institutions to protect their assets. The protection of financial institution creditors under the enterprise insolvency legal framework has a direct impact on the safety of the financial institutions' assets. The existing laws governing enterprise insolvency mainly include the *Provisional Enterprise Insolvency Law* applied to the state-owned enterprises, Chapter XIX (Debt repayment procedures for the insolvency of corporate legal entities) in the *Civil Procedure Law* applied to other enterprises, and a series of judicial explanations promulgated by the Supreme People's Court. However, these laws have not adequately protected the rights of creditors. In terms of the building of insolvency legal system, the bankruptcy administrator system commonly adopted as an international practice has not been established in China, and the current bankruptcy liquidation system often ignores the interests of creditors in liquidation. In terms of the bankruptcy procedures, relevant rules on the administration and acceptance of the insolvency cases, creditors' meeting, and supervision system are not complete in the existing legal system, which further weakens the protection of creditors' rights by the law. As the last resort to protect the claims of financial institutions, if the insolvency law fails to fully protect the interests of the creditors, non-performing loans and credit risks will probably accumulate in financial institutions.

Currently, legislation of the new *Enterprise Insolvency Law* has entered a critical stage. Compared with the existing law, the new one (the second draft) on the one hand extends its application by including all the corporate legal entities under its umbrella, and enriches the provisions on insolvency procedures on the other hand by improving the protection of creditors' rights in every aspect. However, defects remain in the draft law concerning the determination of repayment priority of claims and criteria of insolvency, two focal points that are closely related to the protection of creditors' rights. Regarding repayment priority of claims, priority is given to employee entitlements over secured debts. Regarding the insolvency criteria, the draft law lists enterprises failing to repay due debts and failing to repay all debts with their assets (in evident insolvency) both as tests for insolvency, which will undoubtedly impose negative impact on the protection of the claims of financial institutions.

Giving priority to employee entitlements over secured debts, which increases the difficulties for the recourse of banking claims and lowers the recovery ratio of non-performing assets, will weaken the ability of financial institutions to dispose of non-performing assets and lead to financial risks. In addition, underprotection of the secured debts will damage the basic principles of laws and the confidence of economic entities in the security system as the last protection. Law also represents a faith. Without a confidence in the law, even the most prudent and systematic law will become a mere scrap of paper. However, the excessively strict tests of insolvency make creditors unable to apply for effecting insolvency of the debtors timely and effectively. Taking "inability to repay all debts with assets or in evident insolvency" as the criteria will prevent the enterprises from entering the bankruptcy procedures until they become absolutely insavable. Under this circumstance, the opportunities to restructure or reconcile the insolvent enterprises will be missed, resulting in a failure to provide maximum protection for the creditor's rights.

Third, weakness in criminal liability investigation for financial frauds and irregularities exposes financial institutions to operational risks. The frequent occurrence of operational risks is one of the big problems for China's financial sector. In particular, financial frauds and irregularities have caused great losses to financial institutions. Based on the analysis of recent cases, financial frauds in China could be divided into two categories: one is to provide false information for the purpose of illegal possession, such as

frauds in letter of credit or negotiable instruments; the other is to swindle money by deliberately providing false financial information to benefit the enterprises instead of illegal possession. In the latter case, the use of the funds stated by the loan applicant is true; however, the applicant may deliberately submit false information to the financial institutions that can mislead the banks' decision in credit authorization. Currently, most of the frauds fall into the second category. In the *Criminal Law*, there are clear provisions on financial frauds aiming at illegal possession. However, there's no stipulation for frauds under the second category, and hence only civil responsibilities could be investigated on such behaviors in accordance with the *Contract Law*. Moreover, some irregularities such as misuse of the investors' settlement funds for stock trading and trust funds of the customers have long existed in the financial sector, especially the securities sector and trust sector, which not only harm the legal interests of the public but also generate huge risks to financial institutions. However, since the existing *Criminal Law* only contains provisions against misuse of customers' funds by the staff of the financial institutions not that by the financial institutions, it fails to provide adequate deterrence for such a malpractice. It is undoubted that the lack of criminal punishment for the above frauds and irregularities will bring negative impact on reducing the operational risks in financial institutions.

Fourth, the lack of laws governing financial institutions and business will increase the potential risks in the financial system. As mentioned above, the increase of cross-market risks has become one of the new factors affecting the stability of China's financial system, which is mainly due to the underdevelopment of laws to timely regulate the newly emerged financial institutions and business. For example, under the existing legal framework, although the financial holding companies are seemingly to be covered one way or another by certain provisions in laws such as the *Law of the People's Republic of China on the People' s Bank of China*, the *Commercial Banking Law of the People's Republic of China,* the *Law of the People's Republic of China on Banking Regulation and Supervision,* the *Securities Law of the People's Republic of China,* and the *Insurance Law of the People's Republic of China*, none of them fully solve the supervisory problems. In terms of the financial business, to supervise various entrusted asset management business, the most active cross-market financial products, the CBRC, CSRC, CIRC each has its own supervisory standards to follow, and there is no unified supervision in this regard. Since the existing laws fail to solve the problems confronted in the supervision of financial holding companies and to provide strict legal definitions for new financial business, potential risks are likely to increase and spread across different financial markets. According to the definition made by the Basel Committee, the cross-market risks undertaken by China's financial institutions are in essence legal risks.

III. Next step in optimizing the legal framework

As China's financial reform is accelerating, the task of preventing financial risks has become more important and challenging. Given the innate risks associated with the financial sector, the legal framework for the sector cannot eliminate all financial risks once and for all. However, a sound legal framework may help deter imprudent risk-taking activities of financial institutions and reduce systemic risks. Furthermore, a favorable legal environment is the precondition for the steady performance of the financial system.

The PBC is stepping up its efforts in improving the legal framework for the financial sector. More specifically, it is facilitating the formulation of the *Regulations on Credit Information Management*; it is actively involved in the amendment of the *Enterprise Insolvency Law* and the *Criminal Law*; it is offering suggestions for the amendment of the *Securities Law of the People's Republic of China*; it is drafting the *Law on Anti-Money Laundering*; and it is doing research on the legal issues concerning the market exit of financial institutions, deposit insurance, legislation for financial holding companies, asset securitization, and entrusted wealth management. We hope to promulgate these laws, regulations and implementary rules as soon as possible so as to effectively regulate certain important financial activities. In a word, China's legal framework for the financial sector should be overhauled - necessary new laws should be drafted, existing laws should be amended as appropriate, and outdated laws should be invalidated.

In the long run, we should not only focus on legislation but also on the enforcement of existing laws. In my view, the core issue of financial legislation lies in a scientific approach. Different stages of the financial sector call for different approaches. At present, financial legislation should focus on improving infrastructure of the financial market, regulating legal relationship concerning financial innovation, advancing the coordination and effectiveness of financial supervision, and making the best use of market self-discipline.

First, we shall approach financial legislation in a coordinated, scientific and comprehensive manner. China's economic reform and financial reform are at a critical period, when the stand-alone strategy no longer meets the requirement. Therefore, coordinated planning and rational thinking should prevail in financial legislation. Specifically, we should gradually promote the integration and consolidation of the financial market through legislation; regulate the trading of homogenous financial products through identical supervisory rules; and ensure the consistency of the infrastructure (such as the rules on issuance, registration, custody, settlement and liquidation) in different markets. We should apply uniform rules in regulating the institutional innovation, business innovation and product innovation of financial institutions. We should also work on the sharing and transmission of financial-risk-related information among financial regulatory bodies. Other laws that support financial development and reform should be amended so as to protect both the creditor and the debtor. The revision of the *Criminal Law* should also reflect the current social environment so as to highlight criminal sanctions on corporate crime and the investigation of individual criminal liability.

Second, we should stick to the protection of the interest of the depositor, investor and creditor. Protecting the interest of depositors of financial institutions and the interest of investors in financial products is always an important factor in the maintenance of the reputation of financial institutions. Our present task is to study the fundamental legal relationship in the financial sector and to standardize the legal relationship concerning financial innovation products. While approving innovation products, financial supervisory bodies should work hard to protect such lawful rights of the investors as the right to know and the right to receive due return. We should step up our efforts in improving the *Insolvency Law*. Under the basic principles of the *Insolvency Law*, we should formulate, while taking into consideration the unique features of bankruptcy of financial institutions, the *Regulations on the Bankruptcy of Financial Institutions*. We should also establish and improve the financial safety network and formulate a series of supporting laws and regulations such as the *Regulations on Deposit Insurance* and the *Rules on Administration of the Securities Investor Protection Fund*.

Third, we should stress both self-discipline and external discipline. In drafting laws concerning financial supervision, we should stress the importance of a sound and complete mechanism for corporate governance by such players as commercial banks, brokers and listed companies. While emphasizing the self-discipline of financial institutions, we should also guarantee the autonomy of these institutions in their operation and leave sufficient room for their future development.

Fourth, we should raise the public awareness of financial risks and rules, which is one of the most effective methods for preventing financial risks and ensuring financial safety. During the process, we should foster the extensive publicity of credit culture, increase the awareness of risk prevention among the public and investors, and preach the virtues of lawful investment.