Distinguished guests, ladies and gentlemen,

I am very glad to have this opportunity to attend the conference organized by the Forum of 50 Chinese Economists and wish to stimulate, through the anticipated discussions, academic research and to contribute to policy-making and reforms. In the process of financial reform, we have spent a huge amount of resources in addressing non-performing loans (NPLs), resolving potential financial risks and avoiding financial crisis. In the next round of financial reforms, there are important areas in which we must take actions, such as financial legislation, especially the insolvency law and laws concerning loan frauds, and certainly accounting rules and standards. Legal issues have a direct bearing on the financial ecology of our economy. At present, some related issues have become acute and important. I would like to take this opportunity to share my views with you and hopefully provide some initial thoughts for further study.

I. With the deepening of economic transition, financial risks have taken variable forms and the potential risks that need to be addressed continue to change

There are many underlying reasons for financial risks. First, the rapid global economic, technological and financial development has made it difficult to address new problems with existing theories and experiences. Among these are the uncertainties in financial stability. Second, in the transition from planned to market economy, some aspects of institution building is still in a vague, non-planned and non-market, or conflicting stage. Third, reality has proved that all kinds of problems in the economy are reflected in the workings of the financial system, which was particularly evident during the Asian financial crisis. Financial risks, if not addressed in a timely manner, could continue to grow and develop into economic and financial crisis. We must put more emphasis on understanding the financial risks and the uncertainties involved. Only by taking timely measures, could potential risks be removed. It is a world-wide experience that the longer the risks are left unattended, the harder it is to solve them. When the economy is in transition, financial risks at different stages takes different forms with their nature and characteristics constantly changing. Some of the important problems we faced yesterday are no longer important today, and some of the minor issues of yesterday have developed into significant ones today. For instance, in the recent past, the most important problem we faced was the disposal of large NPLs. In 1998, 270 billion yuan of special treasury bonds were issued to re-capitalize the state commercial banks. In 1999, asset management companies were set up to take over 1000 billion yuan of NPLs. At the end of 2003, Bank of China and China Construction Bank introduced share-holding reform on a trial basis. The two banks wrote off non-performing assets with existing capital, which was followed by state capital injection with foreign exchange and gold reserves. The reform of rural credit unions was stepped up with financial support from the government.

In order to tackle the NPL problem at its root, we conducted a detailed survey and obtained a general picture of the historical causes of NPLs. This work provided a basis for addressing the NPLs and designing the blueprint of state commercial bank reform. According to this survey, 30 percent of the NPLs resulted from state planning and administrative intervention, 30 percent was due to defaults of state enterprises after state banks providing financing based on state policy, 10 percent came from structural adjustments as a result of state orchestrated closure, merge and transformation of enterprises, 10 percent stemmed from intervention of local governments including poor creditor protection in the judicial and enforcement process, while 20 percent was due to the inappropriate internal management. In addition, factors, such as poor credit culture, intentional defaults and inadequate application of accounting standard, can be found in all above categories. One striking truth is that many of these causes related to legal, judicial and enforcement practices.

As old problems are gone with reforms, new ones begin to emerge. For instance, some of the past causes of NPLs, such as policy lending, inappropriate administrative intervention, unbalanced central-local relations and poor internal control within commercial banks have begun to dissolve. At the beginning of reforms, the thinking of administrative separation of powers between the central and local
governments had an adverse impact on the effectiveness of internal controls within commercial banks. In such a setup, loan organization was decentralized to provincial, regional, city and even county level and a “three-eye practice” being followed with each eye looking separately at the head-office of the bank, the local government and the supervisor, the local branch of the People’s Bank of China (PBC). At the early stage of reform, telecommunication was not as developed as today so the daily operation and supervision were, to a great extent, subject to the control of local interests. This led to weak internal controls within banks. When I was working at a commercial bank in the early 1990s, I found that there were many detailed rules and regulations. From appearance, the institutional building was sound, but people at the head-office knew that implementation was usually another story. Therefore, making rules and regulations was to a great extent a means of shirking responsibility. The branches were operating with three eyes and any mistakes resulted would not be the responsibility of the head-office.

It was not until the convening of the 3rd Plenary Session of the 14th National Congress of the CPC in 1993 that emphasis was placed on strengthening internal controls within banks. At the time, it was stressed that specialized banks needed to be transformed into comprehensive, enterprise-like, commercial banks without direct administrative controls. However, changes always take time. It was not until 1997 when lessons from Asian financial crisis were learned and when the Central Financial Work Conference was held that the commercial banks started to introduce vertical management of business and staff, creating needed conditions for strengthening internal controls.

Other causes of NPLs, such as those associated with inadequate supervisory system and the state owned enterprises, have been changing and gradually diminishing. For instance, one problem with the supervisory system at the early stage was, put it simply, “tighten licensing and loose supervision”, i.e. once a license was issued, no supervisory follow-up. After the Asian financial crisis, the Chinese government basically stopped administrative intervention in state-owned commercial banks as laws defining banks’ lending autonomy were put into place. Starting from the beginning of this century, the government has gradually refrained from asking the state-owned banks to follow policies that favor state owned enterprises. As the SOEs reform deepened, some big SOEs became public listed companies and the improvements in business operation also allowed commercial banks to improve asset quality. In general, the old NPL problem is being resolved. As the economy enters a new stage of development, there are going to be many new problems that would require our attention.

It is for the above reasons, the Research Department of the PBC finished a report on the potential financial risks facing China. According to the report, financial risks may arise from nine aspects: the high saving rate and the rapid rise of M2 lead to high concentration of financial risks in the banking sector; the stability of the value of RMB is still under great potential pressures; the experiences around the globe prove that financial instability may arise from fiscal deficits; rigid exchange rate system and imbalances of payments contain significant risks; bank clients and bank-enterprise relationship also hold significant risk; some existing governance problems may require further state financial rescue if not addressed timely; the lack of autonomy and scientific techniques in pricing loans may give rise to significant financial risk; the inadequate innovation mechanism may lead to rigidity that constrain competition; and, a balance needs to be struck between maintaining financial stability and preventing moral hazards.

Many of the above relate to the legal problems in our financial ecological environment. For instance, looking at the bank-enterprise relationship, the Chinese enterprises have high financial leverages with low self-owned capital and relying mainly on bank lending. Can banks completely rely on external information or have to resort to internal information to some degree? When default happens, would the legal arrangements be helpful to protect creditor rights and minimize the losses? Risks in the economy make the forming of NPLs unavoidable, yet in the process of disposing of NPLs, how much control do banks have as the creditors? As for the bank-enterprise relationship should it be control-oriented or be at-arms-length? Answers to the above relate closely to legal conditions or “established practices” and concern accounting standard, external auditing, disclosure, law enforcement, and accessibility of market information. In bank-enterprise relationship, in addition to normal checks and balances, the more important thing is whether the banks have a deterrence of last resort against the borrowing enterprises. As a creditor, the bank would wish the borrowing enterprise to fix its problems as soon as possible. Even so, it is inevitable that some enterprises go default. In the later case, it is a key issue whether the legal arrangements and claims can be ensured effectively and efficiently in line with the insolvency law.

Maintaining financial stability and preventing moral hazards are also closely related to the legal environment. Without an explicit legal framework for closing and liquidating financial institutions, we
may take measures without legal basis and cannot guarantee being “fair and square” in addressing financial stability issues. This may have social stability consequences as the laws do not define clearly the rights and responsibilities of the investors and depositors and that the market participants have no expectation of risks and could not make informed decisions. Whether the market participants can and how they should discipline financial markets and financial institutions also demand clarifications on the base of law.

II. Issues currently under debate

Today, I would like to raise a number of topical issues again, namely, insolvency law, loan frauds, and accounting standards that relate to loan frauds.

1. Insolvency law

It has been long since financial reform and enterprises waited for an up-to-date insolvency law. The provisional Enterprises Insolvency Law was enacted in the early stage of economic transition. As the market economy evolves, the law has become outdated in terms of coverage, liquidation and restructuring arrangement. Despite subsequent amendments and legal interpretations of the law when it was applied in the GITIC case, the law in its present form cannot provide the standard financial discipline and constraints required by socialist market economy. I learnt about some of the arguments over the new draft of the law. My concerns lie in four aspects.

First, the process of liquidation, which involves giving priority to secured claims. Some are in favor of employees’ entitlements being paid ahead of the secured claims. Unpaid entitlements usually are understood to be unpaid salary, yet in a broader interpretation they could also cover unpaid basic social security, pension, healthcare and displacement or reemployment of workers. Without a clear-cut definition of unpaid employees’ entitlements, the ambiguity may result in a low recovery rate of secured claims. In addition, issues concerning pension, healthcare insurance, re-employment are still in the stage of debate and are not clearly defined themselves.

Second, the test for entry into formal insolvency process. According to legal theories, generally an enterprise can be sued for bankruptcy if failing to honor its due debts, which implies that the creditor can use bankruptcy suits as a deterrence to force an enterprise to repay debt. If this cannot succeed, court procedure could begin, in which case, an administrator will be appointed, creditors committee established, and all rights of control and management over the enterprise be taken over by the creditors. The process is crucial for protecting the interests of a creditor. In reality, many of the lawsuits brought up against debtors do not intend to force enterprises into bankruptcy but rather to either increase the pressure for the enterprises to honor their debts or provide an opportunity for enterprises to restructure. In the restructuring process, the creditors can revive the insolvent enterprises through debt relief, extension and rollover in contrast to dismantling them and collecting a heap of useless wreckages. However, if using "balance sheet test", the effectiveness of bankruptcy litigation will be compromised, leaving a seemingly good-looking shape without any meaningful substance. Especially, balance sheet insolvency involves accounting issue and thus is subject to distortion and manipulation, to which I will come back later. This relates to whether the insolvency law plays a role of hard constraint or soft constraint and this concerns whether the transition can go out of what Cornell called "soft financial constraint".

Third, whether insolvency law is a specialized law that requires the establishment of a specialized court. In appearance, there is nothing complicated about insolvency law. If an enterprise fails to honor its due debt, it will be sued for bankruptcy. However, a court may need very specialized knowledge to render the case when it involves complicated claim structure, conflicting tax requirements, employees’ claim, and especially restructuring. For instance, different claims, such as collaterals, superior debts, subordinate debts, have different repayment priority; while, restructuring, similar to merger and acquisition, is a very complicated process. There are always doubts about whether local courts can do a good job in dealing with insolvency cases.

Fourth, whether financial institutions should be covered under a general insolvency law. According to international practice and recommendations of IFIs, financial institutions should be subject to a general insolvency law. Another view is that as bankruptcy of financial institutions would involve depositors and creditors, without a deposit insurance system and investor compensation fund, the liquidation of financial institutions would be much more complicated. For this reason some people are in favor of “special treatment by the State Council” when it comes to financial institutions. Whether this will result...
in a prolonged process of enacting a financial institution insolvency law? Then there will be endless debates and may prevent a deposit insurance system and investors compensation system being put into place in the near future.

2. **Loan frauds**

Based on what have happened in the country, financial frauds can be classified into two categories. One is that through providing false information to reach the goal of illegal possession of financial assets. What is typical of such frauds is that the criminal has the intention of gaining ownership of financial assets through illegal means such as making false use of funds or providing false certificates for ownership of funds. Letter of credit frauds and frauds with financial bills are all examples of such schemes which are regarded as illegal by the Chinese laws. Second, the agent does not have the intention of illegal possession of funds, but it is carried out through intentionally providing false financial information in order to obtain loans from banks for the benefit of the enterprise. In such frauds, the agent’s statement of the purpose of the loans is true, i.e. the agent does not have the purpose of taking the money for himself, but it intentionally provides the banks with false financial information of the enterprise to misguide banks in decision-making. At present most of the financial frauds are of the second kind.

At present, Article 193 of the *Criminal Law of China* has explicit stipulations against frauds with intended illegal possession of funds. However, as for the second kind of frauds, they are not regarded as financial frauds by law since the purpose of providing false information is not illegal possession of funds but rather to obtain bank loans. Criminal charges will only be filed when illegal possession of loans has happened. Otherwise, only civil charges can be brought up against the agent under *Contract Law*. The lack of legal deterrence will have significant impact on setting up strict financial disciplines and whether banks will accumulate large amounts of NPLs.

According the international comparison done by KPMG, frauds stemmed from false financial information has come to the center of attention in many countries. Germany, U.S. and U.K. have made it very clear that financial frauds using falsified financial information is subject to punishment under criminal law rather than civil law. For example, in the *German Criminal Code*, Article 265 b stipulates that using untrue or incomplete documents, submitting untrue or incomplete written statement or giving no references about the true financial situation that is of significance for lending decisions of a bank are financial frauds. The US criminal law also contains similar stipulations with emphasis on the agent’s intent rather than whether a purpose was fulfilled. And the credit or loans include all kinds of loans, loan commitments and guarantees and cover not only the application stage but also the credit renewal and rollover stage. The truthfulness requirements of the British law are similar to those in German and US laws, and treat reckless forecast as one of the conditions for criminal charges.

3. **Accounting standards**

Frauds using falsified financial information have direct connection with accounting standards. False information is either made-up information with no support from actual projects or relates to accounting standards and codes. Since the beginning of reform, China has made progress in improving accounting codes. Apparently, the designing and implementation of accounting codes can influence information truthfulness and give rise to the opportunities to produce false information.

Accounting codes is a very technical issue. Many think the accounting codes as a “steel ruler” that allows no vagueness. However, the complexity of modern economy has put some areas of accounting subject to discretion and interpretation or even personal preference which result in a ruler with flexibility. The issue of accounting codes did not attract much attention at the beginning of the reform. It was not until 1993 that reforms were witnessed in corporate accounting and regulations. During the Asian financial crisis we made more concrete progress in improving the account rules, which we should recognize and value. At the same time, we should also be mindful that more should be done to bring our accounting rules up to the international standards. Some people still think in China we have too complicated an accounting system including a corporate accounting system and also distinctive accounting systems for different industries. For instance, some corporate accounting rules require enterprises to build value-loss reserves based on the recoverability of assets. Although accounting rules of different industries have similar requirements, they are all inadequate in terms of soundness comparing to corporate accounting rules. Another issue is that, since we did not have the luxury of a strong accounting industry and external auditing facilities, when banks assessed the reliability of enterprises’ financial information, they did not require borrowers to provide external auditing results. In
the active role played by the local government, which has wielded its power in re-enforcing judicial,

the recovery rate is an encouragingly 30 percent, higher than expected. This could be contributed to

The second example is about a bank that sold its NPLs in a package to the local government. So far

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There are many interesting cases. Here I would talk about a few and stay away from the

frauds will continue to be high.

I would very much like to hear the comments on what I have said from experts and researchers present today. Your opinions will be instrumental to our work.

III. Impact of legal environment on financial ecology

Legal environment has a direct impact on financial ecology. To some extent, in the transition from a

planned economy to a market economy, one fundamental issue is "soft financial constraint". Whether it

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The first one is of the recovery rate of AMCs. When they were established in 1999 to take over the

NPLs from state commercial banks, we invited renowned and very experienced experts and officials

from the World Bank and Eastern European countries to make an estimation of the recovery rate. In

private they thought it could reach 40 percent to 45 percent with a precondition that improvements

being made in legislation, judiciary system and enforcement to buttress the recovery and restructuring

work. Seeing that the enterprises were running and selling products as usual even with low capital and

heavy historical and social burdens, they thought these enterprises could survive as long as their

burdens could be removed. However, judging from the actual outcome, the NPL recovery rate was

lower than 20 percent. Even though NPL disposal has not come to an end, as time goes by, only the

assets of worse quality left and the recovery rate would be even lower. The overall recovery rate

depends on many factors, such as the process of diversification of ownership, but most importantly, it

hinges on the legal system of the financial ecology: is there an applicable insolvency law? Are there

specific laws regarding asset disposal? In 1989 the Financial Institutions Reform, Recovery and

Re-enforcement Act of the US laid a specific legal framework for restructuring RTC. In Poland, banks

are given semi-judicial powers in negotiations with debtors in enterprise restructuring and bank-
dominant “out-of-court settlement” has strong legal power. In addition, Sweden, Romania, Bulgaria

and other countries have made protective arrangements, giving priority to creditors in asset

restructuring and recovering. Whether a specialized court should be set up? Whether foreclosure of

collaterals can be removed in order to uphold ownership of collateral in a simple and expedient way?

These questions are the preconditions for setting up AMCs and raise recovery rate. For this reason, a

book entitled Reconstruction and Rejuvenation-International Experiences in Resolving Non-performing

Loans was published when 4 AMCs were set up in 1999. While pointing out the importance of

improving banks internal controls, the book emphasized the importance of improving the legal system,

including Guarantee Law, Negotiable Bills Law and Securities Law, and strengthening law

enforcement and especially clarifying creditors’ and debtors’ rights and responsibilities. Furthermore,

the book calls for revamping of the bankruptcy law as in reality, a large proportion of NPLs derived

from abusing the bankruptcy procedure with a certain amount of false bankruptcies and those either
due to loopholes in the legal system or administrative impediments. Certainly, the low recovery rate

can be partially attributed to internal incentives, bureaucratic working style and ineffective work with

the AMCs. But the impact of inadequate legal system on low recovery rate as well as on national

economy should not be underestimated. This is not only because 1 trillion yuan worth of NPLs were

transferred to the AMCs but also that Bank of China and the China Construction Bank transferred

another 300 billion yuan NPLs at market price to Sinda AMC. Similar things will happen in the reform

of the Industrial and Commercial Bank of China and the Agricultural Bank of China. The difference of a

good legal, judicial and enforcement system and that of a bad one can be in the scale as much as

several hundred billion to a trillion yuan of cost to the country.

The second example is about a bank that sold its NPLs in a package to the local government. So far

the recovery rate is an encouragingly 30 percent, higher than expected. This could be contributed to

the active role played by the local government, which has wielded its power in re-enforcing judicial,
enforcement and restructuring processes and making arrangement to deal with employee entitlements such as retirement, laid-off, and health care benefit. Despite the better outcome than what a bank alone could have achieved, this practice itself is not without controversy. Because it raises two questions: first, whether the bank as the creditor is in a disadvantaged position in that it has no controlling power over the borrowing enterprise; second, whether the administration is more powerful than the market. There is a saying about law suits concerning defaults, which is that even if a creditor sues, the court may not take the case; even if it takes the case, it may not hear the case; even if it hears the case, it may not adjudge; even if it adjuges, the ruling may not be enforced. Banks often complain they lose money even when they win default lawsuits. In bankruptcy cases, this is common too, and of course banks don’t always win. As a result, commercial banks and AMCs seldom resort to bankruptcy procedures against debtors, because it may result in a series of unknown events, such as whether it may bring even bigger moral hazard risks? An enterprise may think if defaults on a loan, the debt servicing responsibility may be transferred to the local government that may help to restructure the loan. This may lead to moral hazards in financial discipline. According to the general rule of market economy, the defaulter may face risks of going bankrupt, and the debt cannot be restructured without consent of the creditor. Second, the reform is heading for lesser government involvement in enterprise management. If the practice in the above case was to be promoted as a successful experience, it might lead to deeper involvement of the administration in enterprise management. Would this be a desirable outcome? In addition, the reason why local government was invited in disposing of the NPLs may be that it can influence the judicial and enforcement institutions. But is this indeed a good thing?

The third example concerns the need for judicial specialization. In some cases, when a rumor surfaces that an enterprise is in trouble, local court officials will quickly go to the local offices of securities firms or commercial banks in other cities or provinces asking that the enterprise’s accounts and assets be frozen. If the staff of these institutions does not cooperate, they are accused of obstructing law enforcement. For example, recently officials from one local high court came to the People’s Bank of China and asked that the accounts of a local government of another province be frozen. Many similar cases continue to arise and underline the need for the establishment of a specialized court to adjudicate complex financial issues.

A fourth example is of bankruptcy dictated by government policy. In such cases, the state-owned enterprises must first pay their historical debts and entitlements to employees. According to government policy, an enterprise may sell its land rights to raise money to make payment even if the land rights have been used as collateral for other loans. If this is not enough, the enterprise can begin disposing of its assets to satisfy its obligations. In this case, the enterprise must first dispose of assets not used as collateral. After these assets have been sold, the enterprise then may sell assets used to secure loans. Accordingly, in these cases banks recoup on average less than 1.2 percent of their loans, many times lower than they expected. If priority is given to employee entitlements over secured debt, and such payment order and conditions be generalized and promoted to apply to all enterprises, banks might be forced to take defensive measures and create unfavorable financial conditions for enterprises.

IV. Microeconomic analysis of financial ecology

The soundness of legal system can visibly change expectations of economic entities at the micro level. From the point of view of borrowers, as long as there are legal loopholes, the borrowers can use intermediate institutions, or through setting up relationship with bank officials or take advantage of incomplete information or using falsified information to obtain bank loans. Without the act of illegal possession of funds, it is hard for banks to bring charges against the borrowers. Even when banks want bring forward bankruptcy law suits, the borrowers can use accounting rules to manipulate statements to show that they do not meet criteria of insolvency to avoid going to court. Even when banks successfully sued, before the court decision, enterprises could postpone paying wage, healthcare and pension or create some entitlement items in order to deplete the liquidation funds and leave nothing to creditors. Anyone who is smart may take advantage of opportunities given by law. And this obviously has significant adverse impact on establishing financial constraints of a market economy.

The perceptions of commercial banks may change too. General Rules on Loans requires to differentiate credit and guarantees (including secured loans). The Rules require secured loans including collateral for payment commitment and LC. Secured loans are often guaranteed. However, if
their priority in liquidation is being lowered, it may create chaos in bank managers’ perception as to whether all loans are treated as credit loans? In a microeconomic sense this may create confusion in banks’ lending practice. In this vein the banking sector earnestly looks forward to an insolvency law that is in line with international practice.

In terms of liquidation order, giving priority to employees’ entitlement definitely makes social and political sense. However, it should be noted that social security issues should be dealt with by the social security system through setting up good pension system, healthcare system, social security system and unemployment insurance system to protect employees’ interests. While the insolvency law should define insolvency procedures with emphasis on fair liquidation rights and protecting creditors’ right. Different issues should be dealt with different rules. Any mismatch of issues and solutions, which is like giving John the medicine to treat the sickness of Joe, would result in the continued existence of soft budget constraint that has been there from the beginning of reform. With problems not being addressed at their roots, larger amount of NPLs may continue to emerge.

V. Macroeconomic analysis of financial ecology

First, if the NPLs remain at a high level and continue to accumulate, a financial crisis may be in the making. Based on lessons learnt from the Asian financial crisis, at the appearance, the crisis started from Thailand and was induced by exchange rate and foreign debt pressures. While in fact, factors such as corporate governance, asset and liability mismatch and out-of-date insolvency law also contributed to the crisis. At present, our financial institution reform is at its most crucial stage. Higher than normal NPL ratio should be avoided. Should we not succeed in our reform of the financial ecology, the NPL ratio would be high and might lead to financial crisis eventually.

To prevent financial crisis, we can certainly intensify efforts to absorb NPLs through such means as increasing interest rate spread and loan loss provisioning. In regard to interest rate spread, we cannot strive for the level seen in industrial countries, but rather aiming at those in big developing countries and countries in transition. From this point of view, the interest spreads in China are in the low range. For deposit and loan of one-year maturity, the interest spread is 3.33 percent compared to 3.6 to 8.5 percent in other transitional countries, 3.82 to 45.11 percent in Latin America and 1.78 to 3.59 percent in industrial countries. Strictly speaking, the interest spreads can be compared and categorized in many different ways. But I don’t have time to go into details today. From the medium- and long-term perspective, the present interest spreads do not go along with the conditions in our financial ecology. We look forward to improving the financial environment but should avoid making only optimistic assumptions.

In theory, NPLs can be absorbed through increasing interest spread. In reality, effectiveness of the insolvency law should be taken into account in determining interest spreads. In the case of ineffective insolvency law, some consider an increase of one percent in the interest spread should suffice, some think 3 percent appropriate. It might actually bring shocks if we did raise interest rate. For instance, when we raised the lending rate by 0.27 percentage points on October 20, 2004, the market was shocked. Raising interest spread could have profound impact on the financial conditions of enterprises and the economy as a whole. At present, the overall earning in the corporate sector is favorable. Given the high financial leverage of enterprises, an increase in interest spread can quickly translate into high financial costs for enterprises and big impact on the economy as well.

Another situation that may arise is that banks may be reluctant to give loans when facing risks and uncertainties in creditor protection. The resulting macroeconomic impact is evidenced by the Japanese experience. Reluctant to lend is a common phenomenon around the world. For instance, last year the loan to deposit ratio in Hong Kong was less than 50 percent. The ratio in China was about 70 percent. If financial bills issued by development banks were counted the ratio could be as high as 80 percent. If the banks cannot extend loans with confidence due to uncertainties in the financial environment and have to lower loan to deposit ratio as a result of new risk management requirement and banking supervision, the impact on growth, employment, and the goal of achieving a wealthy society should not be underestimated. While if neither increasing spreads nor withholding lending is feasible, the result may be that NPLs grow and accumulate and new actions are required.

When it comes to absorbing NPLs, I would like to cite an analogy. When you think the tail of your cat needs a trim, you’d better cut it once and for all. If you cut it one time after another, each time both you and your cat have to endure pain and struggling. Unfortunately this is a high probability event. Hungary, a country that started reform much earlier and experienced radical transition, has had to cut
the “tail” three times so far in reforming its banks. Very few countries can claim success after just one operation. Even the very few that had succeeded had to endure the painful cost of high inflation. In sum, the impact of financial environment on macroeconomy is an issue that deserves special attention.

VI. Emerging international consensus and standards

The legal issues concerning financial ecology have always been at the center of attention in the evolution of the views of international organizations and the emergence of international standards. At the G20 ministers meeting held on November 20-21, 2004 in Berlin, Germany, the G20 issued a paper entitled Financial Institutional Building, which summarized the consensus among the G20 members on the priorities of institution building in the financial sector. Out of all of the elements, the G20 first stressed the importance of improving the legal framework, and pointed out that implementing and enforcing credit rights (such as collaterals) protection can contribute to improving financial services and deepening financial markets. In order to strengthen the effectiveness of court adjudication and clarify expectations toward court system, reducing corruption and stepping up training for judges and administrators are also very important. The G20 noted that providing collaterals is one of the standard measures for preventing credit risk and reducing the cost of capital. Indeed, collaterals are usually a necessity for obtaining long-term loans from banks. For collaterals to play its role, one basic condition is that to “ensure effective liquidation and solvency mechanism are in place”. In this regard, G20 Deputies welcome and support the efforts of World Bank in drafting the Principles and Guidelines for Effective Insolvency and Creditor Rights Systems. They also emphasized that the drafting of these principles should take into consideration legal situations in different countries and the special needs of the emerging market economies.

In order to prepare an economically viable, flexible and broad-based principles and guidelines that reflect the varied legal systems and cultural backgrounds, the World Bank enlisted more than 70 international experts during the consultation process. Since 2001, the World Bank had carried out assessments in 20 countries with different legal culture against the Principles and Guidelines (draft) with the purpose of learning experiences and improving the draft.

The revised Principles and Guidelines will be released in the near future. By now consensus has formed on four aspects in regard to the revised draft. For emerging market economies, the revised version stressed the importance of streamlining the claim recovery process. The revised draft emphasized the protection of creditors’ right and the priority of creditors’ claims in liquidation. At the same time the revised draft also recommended the general liquidation process and insolvency law be applicable to all enterprises, minimizing the number of exceptions. In this regards, the World Bank will not recommend to separate financial institutions’ liquidation from the general insolvency law. On the process of liquidation, the revised draft no longer recommends, “automatic freezing of debtors assets”, but rather, “orderly freezing and requiring the court to notify the public.”

International financial institutions, including the IMF, have put the emphasis on developing countries’ putting into place well-designed insolvency law, liquidation process and well-designed legal and enforcement system and process on disposal of NPLs. In its 2001, Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, the World Bank proposed 35 basic principles and guidelines.

Among them, the Principle 3 stresses “security interest legislation”, which includes, “the legal framework should provide for the creation, recognition, and enforcement of security interests’ and that the law should provide for the following features, “security interests in all types of assets, movable and immovable, tangible and intangible, including inventory, receivables, and proceeds; future or after-acquired property, and on a global basis; and based on both possessory and non-possessory interests”; “security interests related to any or all of a debtor’s obligations to a creditor, present or future, and between all types of persons;” “Methods of notice that will sufficiently publicize the existence of security interests to creditors, purchasers and the public generally at the lowest possible cost;” “Clear rules of priority governing competing claims or interests in the same assets, reducing priorities over security interests as much as possible.”

The Principle 4 recommends “recording and registration of secured rights”. And the Principle 5 recommends “enforcement of secured rights”, which includes, “enforcement systems should provide efficient, inexpensive, transparent and predictable methods for enforcing a security interest in property. Enforcement procedures should provide for prompt realization of the rights obtained in secured assets,
ensuring the maximum possible recovery of asset values based on market values. Both non-judicial and judicial enforcement methods should be considered.”

The Principle 11 stresses, “governance,” which says, “in liquidation proceedings, management should be replaced by a qualified court-appointed official (administer) with broad authority to administer the estate in the interest of creditors.”

The Principle 16 is on “claims resolution: treatment of stakeholder rights and priorities”. It recommends, “the rights and priorities of creditors established prior to insolvency under commercial laws should be upheld in an insolvency case to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rules should occur only where necessary to promote other compelling policies, such as the policy supporting rehabilitation or to maximize the estate’s value. The bankruptcy law should recognize the priority of secured creditors in their collateral….In distributing proceeds to secured creditors, public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.

The Principle 27 is about the “role of courts”, which includes, “bankruptcy cases should be overseen and handled of by an independent court or competent authority and assigned, where practical, to judges with specialized bankruptcy expertise. Significant benefits can be gained by creating specialized bankruptcy tribunals.”

The Principle 28 concerns “performance standards of the court, qualification and training of judges”. It recommends, “standards should be adopted to measure the competence, performance and services of a bankruptcy court. These standards should serve as a basis for evaluating and improving courts. They should be enforced by adequate qualification criteria as well as training and continuing education of judges.”

In sum, the reason that I chose to talk about financial ecology was because I hope China will soon enact an insolvency law which supports the socialist market economic reform and hope amendments will be made with regard to loan fraud articles in the criminal law and improvements be made in accounting standards. From the perspective of the central bank, I wish all of you work together to further explore, intensify research and lend support to the development and reform of our financial system in regard to putting into place normal financial order, establishing hard financial constraints and establishing the fundamental framework of socialist market economy.