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Regulation of Financial Conglomerates in China: From *De Facto* to *De Jure*

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Abstract

Financial operations and the regulation thereof have undergone drastic changes in China in the past few decades. Among these changes, the emergence and development of various financial conglomerates are quite noteworthy. At present, such financial conglomerates mainly exist in a de facto *sense, due to the lack of corresponding specific laws and regulations. The regulatory structure is also immature in this respect. In particular, no meaningful coordination mechanism exists among different sectoral regulatory authorities, and the division of supervisory responsibilities in relation to financial conglomerates remains to be clarified. Different factors taken into account, it is submitted that a single mega-regulator is not desirable for the time being, while an effective coordination mechanism based on separated, functional regulation, with the central bank as the leading coordinator, is a more realistic and potentially better choice for China.*

Keywords: financial conglomerates, cross-sectoral financial operations, separated regulation, integrated regulation, single regulation, regulatory coordination, central bank.

1. Introduction

Since the mid-1990s, China has generally mandated a separation of different financial businesses, especially of commercial banking from securities business.[1] In revising the Commercial Bank Law in 2003 and the Securities Law in 2005, respectively, the Standing Committee of the National People's Congress (NPC) made an exception to this requirement by adding the proviso 'unless otherwise provided for by the State',[2] thus leaving more room for cross-sectoral financial

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[1] See Article 43 of the Law of the People's Republic of China on Commercial Banks (*Zhonghua Renmin Gongheguo Shangye Yinhang Fa*, which was promulgated and took effect in 1995, herein 'Commercial Bank Law'): 'No commercial banks shall, within the territory of the People's Republic of China, engage in trust investments and stock operations, or invest in real estate that is not for their own use. No commercial banks shall, within the territory of the People's Republic of China, invest in non-banking financial institutions and enterprises…', as well as Article 6 of the Law of the People's Republic of China on Securities (*Zhonghua Renmin Gongheguo Zhengquan Fa*, which was promulgated in 1998 and took effect in 1999, herein 'Securities Law'): 'Securities business shall be engaged in and administered separately from the banking business, trust business and insurance business; securities companies shall be established separately from banks, trust companies and insurance companies.'

[2] The revised Article 43 of the Commercial Bank Law now reads as follows: 'No commercial banks shall, within the territory of the People's Republic of China, engage in trust investments and securities operations, or invest in real estate that is not for their own use or in non-banking financial institutions and enterprises, *unless otherwise provided for by the State*.' [emphasis added]

The revised Article 6 of the Securities Law now reads as follows: 'Securities business shall be engaged in and administered separately from the banking business, trust business and insurance business, and securities companies shall be established separately from banks, trust companies and insurance companies, *unless otherwise provided for by the State*.' [emphasis added]

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operations.[3] The legislator did not, however, specify a change of the corresponding regulatory structure, but instead authorised the State Council, the central administration of China, to establish a regulatory coordination mechanism,[4] which however still needs to be realised.

On the other hand, even before this far-reaching revision, various financial conglomerates existed in China, either as a legacy of history or through special, case-by-case application and approval, or simply through the use of regulatory loopholes. Now that the revision has potentially removed the statutory barrier to the formation and operation of financial conglomerates, it is however imaginable that financial conglomerates will be developing in a wider and more rapid way.

All this calls for an effective regulatory system. The current financial regulatory system in China is based on the principle of 'separated operation, separated regulation', with different sectoral regulatory authorities supervising different sectoral financial institutions. Such a system generally functions well but appears to be inadequate in reacting to the development of financial conglomerates. A major problem is the lack of a meaningful coordination mechanism among those sectoral regulators, resulting in a regulatory overlap or vacuum. Thus, it is of first priority to establish such a mechanism and clarify the respective responsibilities of the regulators in relation to financial conglomerates.

Meanwhile, there is a large body of opinion in favour of establishing some form of integrated regulatory structure or single-regulator model in China. However, putting aside the question of whether having a single regulator is the ideal option, which is far from being resolved,[5] a more significant question is whether such a model suits China. Without going into detail, the single-regulator model usually presupposes a mature financial market and abundant regulatory practice, implicates tremendous cost of institutional consolidation and entails a high concentration of regulatory powers. China does not seem to be well prepared for such a big change. Indeed, the author argues that, at present, the establishment of a meaningful coordination mechanism based on separated functional regulation and focused on resolving major regulatory conflicts is a better choice.

This article is divided into six parts. Section 2 broadly discusses the development of financial conglomerates in China. Section 3 introduces three categorical examples of

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[3] Arguably, the language of the original separation requirement before 2003 did not rule out cross-sectoral investment completely, as further discussed in section 5.1.1. Nevertheless, the revision, by adding the proviso, has offered financial institutions more possibilities.

[4] See Article 9 of the Law of the People's Republic of China on the People's Bank of China (*Zhonghua Renmin Gongheguo Zhongguo Renmin Yinhang Fa*, which was promulgated and took effect in 1995, and was revised in 2003, herein 'Central Bank Law'), which requires the State Council to establish a coordination mechanism for financial supervision and administration and formulate the specific rules thereof.

[5] See generally José de Luna Martínez and Thomas A. Rose, 'International Survey of Integrated Financial Sector Supervision', World Bank Policy Research Working Paper 3096 (July 2003).

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Chinese financial conglomerates, i.e., the Ping An Group, Bank of China and CITIC Group. Section 4 looks into the existing laws and regulations of China with respect to the supervision of financial conglomerates, and section 5 discusses their insufficiencies. Section 6 offers some thoughts and suggestions on the improvement of the current legal framework and regulatory structure, drawing experience from the United States and the European Union. Finally, there is a brief conclusion in section 7.

2. General development of financial conglomerates in China

2.1 Definition and types of financial conglomerates

There is no uniform definition of the term 'financial conglomerate'. Basically, it refers to an organised business group whose primary activities are financial in nature and which engages to a significant extent in at least two of the activities of banking, insurance and securities.[6] The forms and structures of financial conglomerates vary from country to country but three models are most popular, namely, the 'universal bank' model, the 'bank parent, non-bank subsidiary' (herein 'bank-parent') model and the 'financial holding company' (FHC) model.[7] The universal bank model prevails in the Continental European countries, most notably Germany, which basically means that a bank may by itself engage in banking and non-banking financial activities without having to set up separate legal entities. The bank-parent model is mostly followed by British financial conglomerates, in which a major commercial bank sets up or holds non-banking financial subsidiaries such as securities or insurance firms. Such a parent company is called an 'operational holding company', indicating that it engages in certain business operations itself apart from holding the shares of other companies. By contrast, in the FHC model, the holding company does not itself engage in any substantive business operations but simply exercises control over its banking, securities or insurance subsidiaries. Such a holding company is called a 'pure holding company' as distinguished from the operational holding company mentioned above.[8] FHCs are most popular in the

[6] See, for example, IOSCO, *Principles for the Supervision of Financial Conglomerates* (London, IOSCO 1992), at p. 3; Joint Forum on Financial Conglomerates (herein 'Joint Forum'), *Supervision of Financial Conglomerates* (1999), at p. 69, available at: <http://www.bis.org/publ/bcbs47.pdf>, last visited on 3 December 2010; European Commission, Directive 2002/87/EC (Financial Conglomerate Directive), Art. 2(14), available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:035:0001:0001:EN:PDF>, last visited on 3 December 2010.

[7] Of course, other types of conglomerates exist, such as those formed through the holding of other financial institutions by a non-banking financial institution as parent company.

[8] For a more detailed discussion of the difference between a pure holding company and an operational holding company, see Wang Wenyu, *Konggu Gongsi Yu Jinrong Konggu Gongsifa* [Holding Company and Financial Holding Company Law] (China University of Political Science and Law Press 2003), at pp. 14-15.

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United States. However, it is worth mentioning that there is no absolute line between different types of financial conglomerates. For example, universal banks in Germany can only engage in banking and securities activities; if they want to get into insurance business, they can only do so by establishing an insurance subsidiary; alternatively, banks and insurance companies may jointly form an FHC. Similarly, the United States, as the 'base camp' of FHCs, allows its national banks to set up 'financial subsidiaries' to carry out non-banking business.

The rapid development of financial conglomerates has been a global trend in recent years. An international survey of integrated financial sector supervision by the World Bank shows that in the 14 countries covered,[9] the market share of financial conglomerates operating in the banking, securities and insurance industries has rapidly increased (market share measured as percentage of assets of financial intermediaries belonging to a conglomerate with respect to total assets of intermediaries in each sector). In the area of banking, the market share of conglomerates increased from 53% in 1990 to 71% at the end of 2001. During the same time period, the market share of conglomerates in the securities sector increased from 54 to 63%, and in the insurance sector from 41 to 70%.[10]

2.2 Development of financial conglomerates in China

2.2.1 *Evolution of the financial business and regulatory structure in China*

The development of financial conglomerates in China is quite a complicated issue. In short, the financial operation and regulation system in China has undergone a three-phase development since 1949, i.e., from 'integrated operation, integrated regulation' to 'integrated operation, separated regulation', and then to 'separated operation, separated regulation'. Before 1979, there were essentially no commercial banks or other modern financial institutions, and the People's Bank of China (herein 'People's Bank'), as the central bank, engaged in all kinds of banking/financial activities. Since then, the four biggest state-owned commercial banks (herein 'Big Four SOCBs' or 'Big Four')[11] were gradually established or revived. Initially, there was no mandatory separation between banking and non-banking activities, and commercial banks were broadly engaged in banking, securities and trust investment business. Meanwhile, other financial institutions, such as insurance companies, securities companies and trust and investment companies (herein 'TICs'), also developed gradually. After 1979 and before 1992, the People's Bank was responsible for the supervision of all

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[9] Including Australia, Canada, Denmark, Estonia, Hungary, Iceland, Korea, Latvia, Luxembourg, Malta, Norway, Singapore, Sweden and the United Kingdom. Mexico also took part in this survey but did not provide market share information.

[10] See Martínez and Rose, *supra* n. 5, at p. 10.

[11] Including the Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BOC) and Agricultural Bank of China (ABC).

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financial institutions and financial activities, acting as omnipotent supervisor. In 1992, the China Securities Regulatory Commission (herein 'Securities Commission') was established and took over securities regulation, with the People's Bank still being responsible for the supervision of all other financial activities. Due to the lack of capacity in diversified operations and of regulatory experience, however, the risk inherent in integrated operation accrued and unfolded, the most serious example being the risk brought about by the TICs' unfettered involvement in financial and non-financial operations, especially investment in infrastructure and real estate projects.[12] As a result, the Chinese government adopted the policy of separated operation and regulation of financial activities in 1993,[13] which was codified in the Commercial Bank Law and Insurance Law promulgated in 1995.[14] The Asian financial crisis in 1997 further confirmed the Chinese government in that choice, as indicated by the establishment of the China Insurance Regulatory Commission (herein 'Insurance Commission') in 1998 and the language of Article 6 of the Securities Law promulgated that same year.[15] Due to the prolonged 'checking-up and rectification' of the TICs throughout the country, however, China experienced a transitional period of *de facto* 'integrated operation, separated regulation' up to 2002 when this comprehensive rectification process essentially came to an end. In 2003, the China Banking Regulatory Commission (herein 'Banking Commission') was established to replace the People's Bank as the major banking regulator, leaving the People's Bank to focus on central bank functions such as monetary policy and financial stability. By then, a system of separated operation and separated regulation had finally crystallised.

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[12] According to the Interim Rules on the Regulation of Financial Trust and Investment Institutions (*Jinrong Xintuo Touzi Jigou Guanli Zanxing Guiding*) promulgated by the People's Bank in 1986, TICs may engage in such operations as trust deposit, trust lending, securities issuance, fixed assets investment, working funds lending, guarantee provision and economic consultation. However, in reality, TICs, by establishing securities companies, insurance companies or even industrial-commercial companies, and by absorbing public deposit beyond their scope of business, engaged comprehensively in banking, securities, insurance and industrial-commercial activities. They were indeed 'financial supermarkets' or universal banks in essence. See Yang Yong, *Jinrong Jituan Falü Wenti Yanjiu* [Legal Issues of Financial Conglomerates] (Peking University Press 2004), at p. 225.

[13] On 14 November 1993, the third plenary session of the 14th Central Committee of the Communist Party of China (CPC) passed the Decisions on Several Issues Related to the Establishment of the Socialist Market Economy (*Guanyu Jianli Shehui Zhuyi Shichang Jingji Ruogan Wenti De Jueding*), which mandated 'separated administration of banking and securities businesses'. On 15 December the same year, the Central Committee of the CPC and the State Council promulgated the Decisions on the Reform of the Financial System (*Guanyu Jinrong Tizhi Gaige De Jueding*), stating that 'state-owned commercial banks shall not invest in non-financial enterprises … insurance, securities, trust and banking businesses shall be operated separately'.

[14] See Article 43 of the Commercial Bank Law (1995); Article 5 of the Law of the People's Republic of China on Insurance (*Zhonghua Renmin Gongheguo Baoxian Fa*, which was promulgated and took effect in 1995 and was substantially revised in 2009, herein 'Insurance Law').

[15] See *supra* n. 1.

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2.2.2 *Main types of financial conglomerates in China*

Despite the general trend towards separated operation in the financial sphere since the early 1990s, a few traditionally formed and specially approved (by the State Council) financial conglomerates continued to exist and develop, most notably the CITIC Group. Meanwhile, in order to reform and modernise the SOCBs, especially to qualify them for listing on stock exchanges, the Central Huijin Investment Limited (herein 'Central Huijin') was established by the central government in 2003 to inject capital in the form of foreign reserve into those banks to enable them to meet their capital adequacy obligations, and in this way Central Huijin controlled ICBC, CCB and BOC.[16] After the securities companies crisis broke out in 2004, Central Huijin also acquired control over several major state-owned securities firms as a result of capital injection and reorganisation. With major banks and securities firms as well as a reinsurance company under its umbrella,[17] Central Huijin is now a mega-FHC in any sense. In addition, since the revision of the Commercial Bank Law in 2003 and the Securities Law in 2005, restrictions on integrated operation have been gradually relaxed and various financial conglomerates emerged in accordance with special rules or by means of case-by-case approval, though general legislation on financial conglomerates is still not in sight.

Consequently, there are roughly three categories of *de facto* financial conglomerates in China at present: (i) financial conglomerates formed by financial institutions establishing or holding other financial institutions, including, without limitation, commercial banks which have set up fund management subsidiaries[18] and/or overseas non-banking subsidiaries (most notably in Hong Kong); (ii) FHCs where a pure holding company holds different subsidiary financial institutions, such as the Ping An Insurance Group (herein 'Ping An' or 'Ping An Group') and the above-mentioned Central Huijin; (iii) mixed conglomerates where large industrial-commercial enterprises hold financial institutions. These conglomerates include the traditional CITIC Group, as well as newer ones formed by private enterprises actively engaged in financial services, such as the Haier Group (a leading white goods manufacturer), the New Hope Group (a leading agribusiness operator) and the notorious Delong Group (herein 'Delong').[19] Among such mixed conglomerates,

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[16] In 2007, Central Huijin was merged into the newly established sovereign fund China Investment Corporation and became a subsidiary of the latter.

[17] A more detailed introduction to the holding structure of Central Huijin is available at: <http://www.huijin-inv.cn/hjen/aboutus/aboutus_2008.html?var1=About>, last visited on 3 December 2010.

[18] This was done first through case-by-case application and approval, and in accordance with the Pilot Measures for the Establishment of Fund Management Companies by Commercial Banks (*Shangye Yinhang Sheli Jinjin Guanli Gongsi Shidian Guanli Banfa*, herein 'Pilot Fund Measures') jointly promulgated by the People's Bank, the Banking Commission and the Securities Commission in 2005.

[19] See discussions below in section 5.1.1.

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CITIC can be said to be financial in nature since financial assets account for nearly 84% of the group's total assets,[20] while others are more tricky to define.[21]

3. BOC, Ping An and CITIC: three categorical examples

3.1 **BOC**

3.1.1 *Shareholding structure of Chinese banks*

Chinese banks used to be exclusively established and owned by the state, hence the name 'wholly state-owned commercial bank'.[22] Later, during the process of reform and modernisation of the corporate structure of commercial banks since the late 1990s, ownership of traditional banks was gradually diversified, one prominent example being the introduction of so-called 'strategic investors', i.e., leading foreign banks or sovereign funds, to better prepare Chinese banks for their large-scale initial public offerings. Then, with more and more banks becoming listed companies on domestic and overseas stock exchanges, public shareholders also began to take their place in the ownership structure. There are also some smaller, privately owned banks, most notably the Minsheng Banking Corporation. All this being said, the Chinese government (the state) remains the overwhelmingly controlling shareholder of major commercial banks, such as the Big Four and the Bank of Communications (the fifth largest commercial bank next only to the Big Four), through Central Huijin and the Ministry of Finance. The same observations apply to major securities firms and insurance companies. This ownership feature has to be taken into account when looking at financial conglomerates formed around such financial institutions.

3.1.2 *The cross-sectoral expansion of BOC as a typical SOCB*

The Big Four SOCBs, which remain the major players in the country's banking industry, have acted quite scrupulously in their march towards becoming financial conglomerates. Generally speaking, these SOCBs did not embark on a full-scale business expansion until 1994 when the State Council initiated the reform of the financial system and called for the adoption of a modern enterprise system. However, taking advantage of its historical strength, the Bank of China (BOC) kicked off an expansion scheme much earlier than its counterparts.

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[20] See *CITIC 2009 Annual Report*, available at: <http://www.citic.com/wps/portal/encitic/gyzx/jtnb?lctn=5&flag=51>, last visited on 3 December 2010.

[21] For a more thorough introduction to *de facto* financial conglomerates and their affiliated enterprises in China, see Xia Bin, et al., *Jinrong Konggu Gongsi Yanjiu* [A Research on Financial Holding Companies] (China Financial Publishing House 2001), at pp. 213-229.

[22] Commercial Bank Law (2003), Art. 18.

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The history of BOC dates back to 1912 when the revolution led by Dr Sun Yatsen overthrew the Qin Empire and founded the Republic of China. Acting as the latter's central bank for 16 years, BOC was changed into a government-chartered international exchange bank in 1928. After the Civil War and the foundation of the People's Republic of China in 1949, BOC was nationalised by the new regime and became a specialised foreign exchange bank. This has provided BOC with a unique advantage in terms of overseas operations, especially in Hong Kong.

Taking advantage of Hong Kong's tolerance of cross-sectoral financial operations, BOC located almost all of its non-banking subsidiaries there.[23] In brief, BOC established China Construction Finance (Hong Kong) Limited in 1979, which marked the beginning of its investment banking business. In 1998, BOC International Holdings Limited, a wholly owned subsidiary of BOC specialising in investment banking, was incorporated in Hong Kong. It is the most internationalised investment bank established overseas by a Chinese bank. Meanwhile, BOC started its insurance business in 1992 when it set up BOC Group Insurance Co., Ltd., which, in turn, set up BOC Insurance Co., Ltd., as a wholly owned subsidiary.

Another breakthrough came in 2004 when BOC, as approved by the Securities Commission and the Ministry of Commerce, established, in Shanghai, the BOC Investment Management Co., Ltd., the first fund management company established by a commercial bank in Mainland China, together with Merrill Lynch Investment Managers (merged with BlackRock in 2006). This company is now jointly held by BOC and BlackRock, with BOC holding 83.5% of the total shares.

Consolidating its multiplied operations in various financial service industries, BOC now has total assets of RMB 8,748 billion (or USD 1,281 billion, based on the year-end middle rate of 2009), with a total profit before tax of RMB 111.4 billion (or USD 16.3 billion) in 2009. Commercial banking remains its primary business, accounting for 95.81% of the total profit, while investment banking and insurance together account for a mere 2.04%.[24] In view of the overwhelmingly dominant position of commercial banking in its business operations, questions might be raised as to whether BOC satisfies one of the two definitional requirements for financial conglomerates mentioned above, i.e., 'engage to a *significant* extent in at least *two* of the activities of banking, insurance and securities' [emphasis added], or more specifically, whether its engagement in the insurance and securities sector can be said to be 'significant'.[25] However, in the absence of a generally accepted, quantitative definition of the word 'significant', there seems to be no solid base for excluding BOC (and similarly other SOCBs) from the world of financial conglomerates.

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[23] In fact, the other three SOCBs (ICBC, CCB and ABC) have also set up their own non-banking subsidiaries in Hong Kong.

[24] See *BOC 2009 Annual Report (H share)*, available at: <http://www.boc.cn/en/investor/ir3/201003/t20100323_989421.html>, last visited on 3 December 2010.

[25] Joint Forum, *supra* n. 6, at p. 64. The other requirement, i.e., the conglomerate's primary business is financial, is obviously satisfied.

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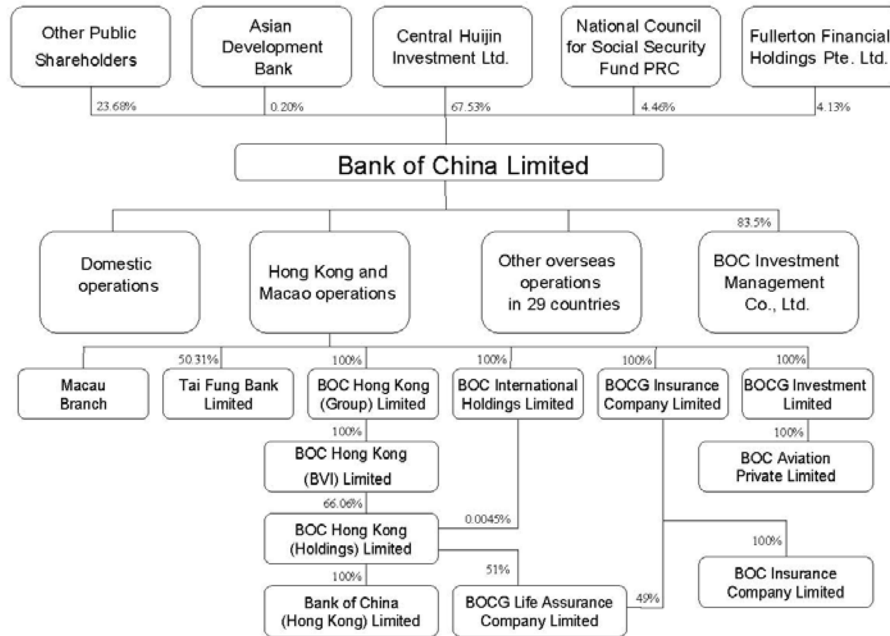
Figure 1: Organisational chart of BOC



Source: Edited from BOC 2009 Annual Report (see *supra* n. 24).

3.2 Ping An Group

The Ping An Group's predecessor was the Ping An Insurance Company established in 1988 in Shenzhen, which was the first insurance company in China to have a shareholding structure. With five insurance subsidiaries (Ping An Life, Ping An Property & Casualty, Ping An Health, Ping An Annuity and Ping An Hong Kong) under its flag, the Ping An Group basically engages in all kinds of insurance business in China.

As to securities and investment business, in 1991 Ping An set up a securities department, which in 1995 was transformed into an independent subsidiary, the Ping An Securities Company, with the approval from the People's Bank. In 1996, like many other financial institutions, Ping An set up a TIC, the Ping An Trust & Investment Company, as one of its subsidiaries. Fortunately, that company was among the first batch of TICs to be given approval by the People's Bank in February 2002 for re-registration, after the prolonged rectification process mentioned above. In 2005, Ping An also established the Ping An Asset Management Company. The business of that company includes underwriting Treasury bonds, trading in the primary interbank bond market and convertible bond market, investing in funds and the stock market, and making private equity and trial infrastructure investments. In

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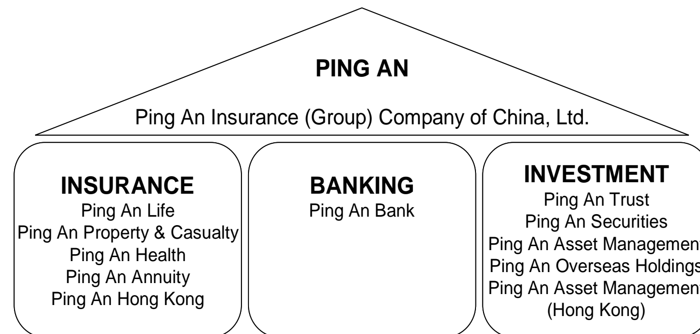
2006, the establishment in Hong Kong of the Ping An Asset Management Company (HK) was approved by the Insurance Commission.

The story of Ping An's banking wing is somewhat more complicated. The present Ping An Bank, the Ping An Group's banking subsidiary, was formerly known as the Shenzhen City Commercial Bank (SCCB), established in 1995, the first urban commercial bank in China. In December 2006, upon the approval of the Banking Commission, the Ping An Group became the largest shareholder of SCCB with an 89.36% shareholding. In June 2007, SCCB was approved by the Banking Commission to acquire and merge with the then Ping An Bank headquartered in Shanghai, and to rename itself as Shenzhen Ping An Bank. In January 2009, the Shenzhen Ping An Bank was again renamed as Ping An Bank. In addition, by July 2010, the Ping An Group, together with its subsidiary Ping An Life, had acquired 29.99% (30% being the threshold for triggering a mandatory tender offer in China) of the shares of the famous Shenzhen Development Bank (SDB), the first company to list its stock on the Shenzhen Stock Exchange, making the Ping An Group the biggest shareholder of SDB. The Ping An Group is reported to be considering further integration with SDB, possibly by merging the Ping An Bank into the latter and holding up to 51% of its shares,[26] though details still need to be worked out and approved by relevant regulatory authorities.

By any token, the Ping An Group as it is today seems to be a typical FHC, or in its own words, an 'integrated financial services conglomerate',[27] with insurance, banking and investment business at its core.

Figure 2: Organisational chart of Ping An



Source: Edited from 'About Ping An' (see *infra* n. 27).

[26] See Wan Min, '"Erheyi" Lujing Jianming, Shenfazhan Huo Dingxiang Zengfa Shougou Ping An Yinhang' [Report: It Has Surfaced That SDB Might Acquire Pin An Bank through Private Offering], 1 July 2010, available at: <http://www.p5w.net/stock/news/gsxw/201007/t3054825.htm>, last visited on 3 December 2010.

[27] 'About Ping An', available at: <http://about.pingan.com/en/index.shtml>, last visited on 3 December 2010.

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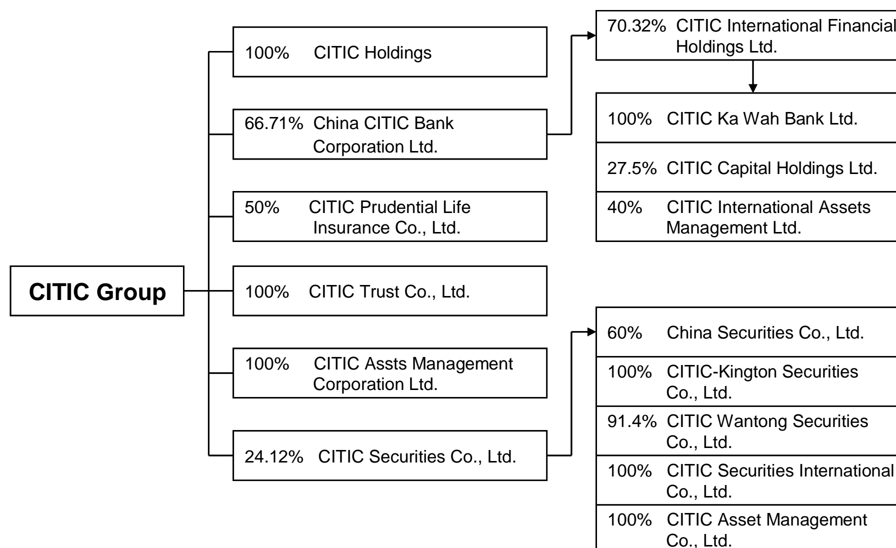
3.3 CITIC Group

The CITIC Group is a symbolic traditional mixed conglomerate in China. Formerly known as the China International Trust and Investment Corporation, CITIC was established in 1979 by Rong Yiren, a famous 'red capitalist' and former Vice-President of China, with the initiation and approval by Deng Xiaoping, as a window showing China's opening-up policy to the world. In more than thirty years since then, CITIC has grown into a large transnational conglomerate, with a total asset of RMB 2153.8 billion by the end of 2009.[28]

Figure 3: Organisational Chart of CITIC (financial business only)



Source: Edited from: <http://www.citic.com/wps/portal/encitic/gyzx/zzjg?lctn=8&flag=81>, last visited on 3 December 2010.

CITIC explicitly classifies its business into financial and non-financial. Its financial services include commercial banking, investment banking, trust, insurance and fund management, while non-financial services broadly cover real estate and infra-structure, project contracting, resources, manufacturing, information industry, and trading and services. Financial services are undoubtedly the group's primary business, accounting for nearly 84% of total assets (RMB 1806.6 billion).[29] It should be noted that CITIC Holdings, established in 2002 upon the approval of the People's

[28] See *CITIC 2009 Annual Report*, *supra* n. 20.
[29] Ibid.

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Bank as a wholly owned subsidiary of the CITIC Group and as a holding company to invest in and manage domestic and overseas financial enterprises, is entrusted by the CITIC Group with managing all the financial enterprises under CITIC's flag (though the shareholder of those institutions remains the CITIC Group, as shown in the organisational chart below). Thus, in a somewhat untypical way, CITIC Holdings and the financial institutions under its business management and control constitute an FHC within the CITIC Group.

It is also worth mentioning that under the CITIC Group, four subsidiaries are listed on the Shanghai Stock Exchange (CITIC Bank, CITIC Securities, CITIC Guo'an and China-COHC, the former two being financial subsidiaries). In a country where initial public offerings and listing of stock are still subject to rigid control and where listed companies are viewed as a sort of 'scarce resource', this fact shows the strong historical link between CITIC and the government. In addition, six CITIC subsidiaries are listed on the Hong Kong Stock Exchange (CITIC Bank, CITIC Pacific, CITIC Satellite, CITIC 21CN, CITIC Resources and CITIC 1616 Hold, the former two being financial subsidiaries), indicating CITIC's strong overseas link.

4. LEGAL FRAMEWORK AND REGULATORY STRUCTURE REGARDING FINANCIAL CONGLOMERATES

As mentioned above, currently there are no laws or regulations[30] specifically addressing the supervision of financial conglomerates in China, despite their actual existence. Generally speaking, present financial laws and regulations are formulated on a sectoral basis, under which banks, insurance companies and securities firms are subject to different groups of laws and to the supervision of different government agencies. However, some of those laws and regulations or the relevant provisions thereof do relate to different aspects of the supervision of financial conglomerates and are worthy of at least a cursory review. This section is therefore intended to clarify the existing legal framework and regulatory structure in relation to financial conglomerates, based on a brief review of selected laws and regulations.

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[30] In a nutshell, there are four tiers of legal documents in China: the 'law' (*Falü*) in its strict sense, as enacted by the NPC or its Standing Committee, being the highest level of law in the country; the 'administrative regulation' (*Xingzheng Fagui*) as promulgated by the State Council, being the second highest level of law; 'ministerial regulations' (*Buwei Guizhang*) as promulgated by the ministries or ministerial-level agencies under the State Council; and 'local law' (*Difang Fagui*) as promulgated by the local People's Congress, ranked below the law and the administrative regulation but in principle equal to ministerial regulations; and finally, the 'local regulation' (*Difang Guizhang*) as promulgated by local governments, situated at the bottom of the pyramid. Due to the limited space of this article, only relevant laws, administrative regulations and ministerial regulations are discussed, and they are generally referred to as 'laws and regulations'.

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4.1 Banking laws and regulations

4.1.1 *Establishment regulation*

The fundamental laws with respect to banking supervision in China include the Commercial Bank Law promulgated in 1995 and substantially revised in 2003, as well as the Law of the People's Republic of China on Banking Supervision and Administration (*Zhonghua Renmin Gongheguo Yinhangye Jiandu Guanli Fa*, herein 'Banking Regulation Law') promulgated in 2003, which established the Banking Commission and shifted to it most of the People's Bank's banking supervisory powers. According to these two laws, the establishment of commercial banks is subject to examination and approval by the Banking Commission. Without such approval, no entity or individual may engage in commercial banking business, such as taking deposits from the general public, or use the word 'bank' in its name.[31] More generally, all banking institutions and their business operations are subject to supervision by the Banking Commission.[32] The minimum amount of registered capital is RMB 1 billion for the establishment of a national commercial bank, and RMB 100 million and 50 million, respectively, for the establishment of an urban cooperative commercial bank and a rural cooperative commercial bank. Such registered capital shall be paid-in rather than nominal capital. In addition, the Banking Commission may increase (but not lower) these thresholds if prudential supervision so requires.[33]

4.1.2 *Capital adequacy requirement*

The capital adequacy requirement is of paramount significance in the supervision of banking institutions. As stated by the Commercial Bank Law, the capital adequacy ratio of a commercial bank may not be lower than 8 percent.[34] This threshold may also be increased by the Banking Commission. In fact, the capital adequacy ratio has been recently raised to 11% (and then 11.5%) for large banks and 10% for medium and small banks, as a preventive reaction to the startling consequences of the global financial crisis.

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[31] Commercial Bank Law (2003), Art. 11.

[32] Banking Supervision Law, Art. 2. Banking institutions include commercial banks, urban cooperatives, rural cooperatives and policy banks. In addition, asset management companies, TICs, finance companies, financial leasing companies and other financial institutions established with the approval of the Banking Commission are also subject to its supervision. Ibid.

[33] Commercial Bank Law (2003), Art. 13.

[34] Ibid., Art. 39(1). This Article also sets out three other asset-liability ratios: the ratio between the balance of loans and the balance of deposits may not exceed 75%, the ratio between the balance of circulating assets and the balance of circulating liabilities may not be lower than 25%, and the ratio between the balance of the loan of one borrower and the balance of the capital of the commercial bank may not exceed 10%. Ibid., Art. 39(2)-(4).

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The Measures regarding the Administration of the Capital Adequacy of Commercial Banks (*Shangye Yinhang Ziben Chongzulü Guanli Banfa*, herein 'Capital Adequacy Measures'), adopted by the Banking Commission in 2004, reiterate that the required minimum ratios shall be no less than 8 percent for capital adequacy and 4 percent for core capital adequacy.[35] They also explicitly mention 'consolidated supervision', which is deemed to be a crucial element in the supervision of financial conglomerates. According to the Capital Adequacy Measures, any financial institution with more than 50 percent of its equity capital owned by the commercial bank in question is eligible for consolidation.[36] Under certain circumstances, the capital of the financial institution will also be consolidated even if the commercial bank does not own more than 50 percent of its equity capital.[37] In a later document, the Trial Guidelines on the Consolidated Supervision of Banks (*Yinhang Bingbiao Jianguan Zhiyin (Shixing)*, herein 'Consolidated Supervision Guidelines'), adopted by the Banking Commission in 2008, the somewhat ambiguous word 'equity capital' was replaced by the clearer term 'voting shares'.[38]

In a further attempt to reinforce capital adequacy supervision in the aftermath of the global financial crisis, the Banking Commission adopted the Guidelines on the Supervision and Examination of the Capital Adequacy of Commercial Banks (*Shangye Yinhang Ziben Chongzulü Jiancha Jiandu Zhiyin*) at the end of 2009. This document states that commercial banks shall meet the Banking Commission's minimum capital adequacy requirements on an ongoing basis and that the Banking Commission has the right to take intervening or corrective measures against those commercial banks whose capital cannot sufficiently cover risk.[39] More specifically, commercial banks shall, on the basis of consolidated management, establish an internal capital adequacy assessment procedure adapted to their risk profile and operational environment. They shall also inform the relevant supervisory agencies of the relationship between the procedure of the parent bank and that of the subsidiary institutions, as well as prove that the capital adequacy requirements are fulfilled at group and single-institution level.[40]

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[35] Capital Adequacy Measures, Art. 7.

[36] This includes that the commercial bank directly owns, or owns through or together with its subsidiaries, more than 50% of the equity capital of a financial institution. Ibid., Art. 10(1).

[37] Such circumstances include: (1) the bank owns more than 50% of the voting shares of the financial institution through agreements with other investors; (2) the bank has the power to control the financial and operating policies of the financial institution in accordance with articles of association or agreements; (3) the bank has the power to appoint and remove the majority members of the board of directors or other decision-making bodies of the financial institution; and (4) the bank owns more than 50% of the voting rights in the board of directors or other decision-making bodies of the financial institution. Ibid., Art. 10(2).

[38] Trial Guidelines on the Consolidated Supervision of Banks, Art. 9.

[39] Guidelines on the Supervision and Examination of the Capital Adequacy of Commercial Banks, Art. 8.

[40] Ibid., Art. 15.

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4.1.3 *Investment in fund management companies*

As mentioned above, commercial banks in China are prohibited from investing in non-banking financial institutions, unless otherwise allowed by the state. One such 'otherwise' occurred in 2005 when the People's Bank, the Banking Commission and the Securities Commission jointly promulgated the Pilot Fund Measures.[41] Basically, this document permits certain commercial banks selected as 'pilot banks' by the People's Bank, the Banking Commission and the Securities Commission to establish[42] fund management companies (herein 'FMCs') which engage in the management of securities investment funds. A commercial bank wishing to establish an FMC shall first apply to the Banking Commission and seek its regulatory opinion on whether the bank is qualified to make such an investment (from the perspective of overall risk supervision) and then apply to the Securities Commission, which is generally in charge of the establishment of FMCs, for examination and approval with respect to the establishment details.[43] To avoid conflict of interests, no commercial bank is allowed to act as trustee for any fund managed by an FMC established by the same bank, or enter into transactions with the latter on terms more favourable than those offered in transactions of the same kind with non-affiliated third parties.[44]

It is also worth mentioning that the Pilot Fund Measures explicitly mention regulatory coordination among the different regulators. In supervising FMCs established by commercial banks, the People's Bank, the Banking Commission and the Securities Commission are required to provide relevant information to one another in a timely manner and to set up a regulatory information-sharing system.[45] In addition, the People's Bank is responsible for the overall coordination of the establishment of FMCs by commercial banks.[46] As discussed below, a qualified coordinator is essential to any meaningful regulatory coordination, and in China such a role is best played by the central bank. At the time of writing, three large commercial banks, i.e., ICBC, CCB and the Bank of Communications, have received approval to establish their respective fund management subsidiaries according to the Pilot Fund Measures.

4.1.4 *Investment by and in insurance companies*

Since 2006, insurance companies in China have been allowed to make equity investments in commercial banks on a regular rather than case-by-case approval

[41] See *supra* n. 18.
[42] According to Article 26 of the Pilot Fund Measures, they may also acquire existing fund management companies.
[43] Pilot Fund Measures, Arts. 6 and 7.
[44] Ibid., Arts. 16 and 18.
[45] Ibid., Art. 25.
[46] Ibid., Art. 5.

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basis.[47] Investment in the reverse direction, however, was not allowed until 2009, when the Pilot Measures for the Administration of Commercial Banks Making Equity Investments in Insurance Companies (*Shangye Yinhang Touzi Baoxian Gongsi Guquan Shidian Guanli Banfa*, herein 'Pilot Insurance Investment Measures') were promulgated by the Banking Commission; these served as a natural continuation of the Memo of Understanding on Regulatory Cooperation and Coordination signed by the Banking Commission and the Insurance Commission earlier in 2008.[48]

According to the Pilot Insurance Investment Measures, any commercial bank wishing to make equity investments in an insurance company shall apply to the Banking Commission and seek the latter's regulatory opinion,[49] and the Banking Commission will then forward the application to the State Council for final confirmation, with each commercial bank being eligible to invest in only one insurance company.[50] To avoid conflict of interests, commercial banks shall not extend credit to any party insured by the insurance companies in which they invest, or extend credit to such insurance companies or their affiliated enterprises, unless otherwise provided for by the Banking Commission.[51] No commercial bank may sell, directly or indirectly, subordinated bonds that it issued to the insurance company in which it invests, and the insurance company may not hold, directly or indirectly, more than 10% of the outstanding other securities issued by the commercial bank or its controlled affiliates.[52] The Pilot Insurance Investment Measures do not set any ceiling on the percentage of shareholding,[53] but commercial banks are required to have consolidated management of insurance companies in which they invest pursuant to the Consolidated Supervision

47 See discussions below in section 4.3.3.

48 The full name is Memorandum of Understanding on the Strengthening of Deep-level Business Cooperation and Cross-sector Regulatory Cooperation between the Banking and Insurance Sectors (*Guanyu Jiaqiang Yinbao Shencengci Hezuo He Kuaye Jianguan Hezuo Liangjie Beiwanglu*).

49 Pilot Insurance Investment Measures, Arts. 6 and 7. The document itself does not mention the approval of the Insurance Commission, but according to the Provisions on the Administration of Insurance Companies (*Baoxian Gongsi Guanli Guiding*) adopted by the Insurance Commission in 2009, a change of any shareholder with a shareholding of 5% or more in a given insurance company needs to be approved by the Insurance Commission (Art. 26).

50 Ibid., Art. 3.

51 Ibid., Art. 11.

52 Ibid., Art. 13.

53 The Measures for the Administration of Equity Interests in Insurance Companies (*Baoxian Gongsi Guquan Guanli Banfa*) newly released by the Insurance Commission in May 2010, however, do require that the aggregate shareholding of a single shareholder (together with its affiliates) in a domestic insurance company (that is, an insurance company with less than 25% foreign shareholding) may not exceed 20% of the registered capital of the latter, unless specially approved by the Insurance Commission. That is why the pilot banks have so far all invested in joint venture insurance companies with more than 25% foreign shareholding. See *infra* n. 55 and accompanying text.

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Guidelines, and must deduct the full amount of such investment from their capital in calculating the capital adequacy ratio.[54] Finally, the Banking Commission is authorised to exercise consolidated supervision over commercial banks investing in insurance companies and to provide, in a timely manner, significant regulatory information in accordance with relevant information-sharing mechanisms.[55] At the time of writing, three commercial banks (BOC, Bank of Communications and Bank of Beijing) have received approval to invest in insurance companies, with a shareholding percentage of 50%, 51% and 50%, respectively, and two other eligible commercial banks (ICBC and CCB) also have investment plans in place, both with a proposed shareholding percentage of 50%.[56]

4.2 **Securities laws and regulations**

4.2.1 *Establishment regulation*

The fundamental law with respect to securities regulation in China is the Securities Law promulgated in 1998 and substantially revised in 2005. According to this law, the establishment of securities companies is subject to examination and approval by the Securities Commission. Without such approval, no entity or individual may engage in securities business.[57] A securities company must carry the words 'securities company' in its name.[58] Subject to approval by the Securities Commission, a securities company may engage in all or part of the following business activities: (1) securities brokerage; (2) securities investment consultation; (3) financial advising related to securities trading or investment; (4) securities underwriting and sponsorship; (5) proprietary account transactions; (6) securities asset management; and (7) other securities business.[59] Accordingly, the minimum amount of registered capital is RMB 50 million for a company engaging in one or all of the business activities in (1) through (3), RMB 100 million for a company engaging in one of the business activities in (4) through (7), and RMB 500 million for a company engaging in two of more of the business activities in (4) through (7). Like the Banking Commission, the Securities Commission may increase (but not lower) these thresholds pursuant to the principle of prudential supervision and the risk level of the various business activities.[60]

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[54] Pilot Insurance Investment Measures, Arts. 14 and 16.

[55] Ibid., Arts. 21-23.

[56] For a more detailed discussion, see Kejie Law Office, *Shangye Yinhang Rugu Baoxian Gongsi Zhi Xianzhuang Ji Fenxi* [An Analysis into the Status Quo of the Investment of Commercial Banks in Insurance Companies], available at: <http://kejielaw.com/upload/newsfile/201006/12771072442839.pdf>, last visited on 3 December 2010.

[57] Securities Law (2005), Art. 122.

[58] Ibid., Art. 126.

[59] Ibid., Art. 125.

[60] Ibid., Art. 127.

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4.2.2 *Capital adequacy requirement*

The Securities Commission is responsible for overseeing the capital adequacy and risk control of securities companies. As stated by the Securities Law, the Securities Commission shall, for securities companies, specify such risk control indicators as the net capital, the ratio of net capital to debt, the ratio of net capital to net assets, the ratio of net capital to the business scales of proprietary account transactions, underwriting and asset management, the ratio of liabilities to net assets, and the ratio of circulating assets to circulating liabilities.[61] The Securities Commission has indeed specified such indicators in its Measures for the Administration of the Risk Control Indicators of Securities Companies (*Zhengquan Gongsi Fengxian Kongzhi Zhibiao Guanli Banfa*), adopted in 2006 and revised in 2008.

4.2.3 *Prevention of conflict of interests and contagion of risk*

To avoid conflict of interests, a securities company is required, when conducting proprietary account transactions, to use its own name instead of that of another entity or of an individual, and to use its self-owned funds or funds raised according to law.[62] In addition, a securities company is prohibited from making any form of commitment to secure the profits or compensate for the losses of its clients arising from the purchase or sale of securities.[63] The notorious example of conflict of interests – insider trading – is also explicitly prohibited by the Securities Law. Basically, it prohibits persons possessing inside information and those unlawfully obtaining inside information from buying or selling the securities of the company concerned or from leaking such information, or from advising other persons to buy or sell such securities.[64] Last but not the least, securities companies are required to have in place a sound internal control system and to adopt effective methods of segregation so as to prevent conflict of interests between the firm and the clients as well as between different clients.[65]

In order to avoid risk contagion from the securities market to commercial banks, the Securities Law used to include a provision stating that 'bank funds are prohibited from flowing into the stock market *against regulations*' [emphasis added].[66] It prohibited, among other things, bank loans from being used in the capital market. This provision, however, appeared problematic. First, 'bank funds' is not a legal term and its meaning is quite ambiguous and difficult to apply. Second, banks' lending or

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61 Ibid., Art. 130.

62 Ibid., Art. 137.

63 Ibid., Art. 144.

64 For the definition of inside information and persons possessing inside information, as well as other details, see Securities Law (2005), Arts. 73-76.

65 Ibid., Art. 136.

66 Securities Law (1998), Art. 133(1).

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investment activities are better regulated by banking laws. Third, the provision reads logically weird: now that any act by any entity *against regulations* is by definition prohibited, what is the sense of singling out banks or bank funds? Finally, the rigid regulatory segmentation between banking and securities sectors has been gradually relaxed over the past few years, which has outdated the underlying ideology of this somewhat cursory clause. As a result, in the revision of the Securities Law in 2005, this provision was replaced by a broader and more neutral one stating that 'the channel for funds to enter into the stock market shall be broadened according to law, and funds are prohibited from flowing into the stock market against regulations'.[67] The omission of the original specific reference to bank funds, together with the declaration to broaden the channels for the flow of funds, is viewed as signalling a future possibility of more integrated financial operation.

As stated above, securities firms are, in principle, still barred from engaging in commercial banking or insurance business *by themselves*, even after the revision of the Securities Law. To be specific, securities business shall be operated and regulated separately from banking, trust and insurance business, and securities companies shall be established separately from banks, trust companies and insurance companies, unless otherwise provided for by the state.[68] Unlike its counterpart in banking law,[69] however, this principle itself does not seem to prohibit securities firms from investing in other financial institutions, e.g., by establishing or acquiring banking or insurance subsidiaries.

4.3 **Insurance laws and regulations**

4.3.1 *Establishment regulation and capital adequacy requirement*

The fundamental law with respect to insurance supervision in China is the Insurance Law, which was originally enacted in 1995 and was extensively revised in 2009. The Provisions on the Administration of Insurance Companies promulgated by the Insurance Commission in 2009, immediately following the revision of the Insurance Law, further sets out the regulatory details in relation to insurance companies.

Basically, insurance business may only be operated by insurance companies established in accordance with the Insurance Law, or by other insurance organisations as specified by laws and administrative regulations; no other entity or individual may engage in insurance business.[70] Insurance business shall be operated and regulated separately from banking, business and trust business, and insurance companies shall be established separately from banking, securities and trust invest-

[67] Securities Law (2005), Art. 81.
[68] Ibid., Art. 6.
[69] Commercial Bank Law (2005), Art. 43.
[70] Insurance Law (2009), Art. 6.

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ment institutions, unless otherwise provided for by the state.[71] The establishment of an insurance company must be approved by the Insurance Commission. The required minimum amount of registered capital is RMB 200 million, which may be increased (but not decreased) by the Insurance Commission according to a given company's business scope and size.[72] In addition, an insurance company is required to maintain a minimum solvency margin adapted to its business size and risk level. The balance of an insurance company's admitted assets minus admitted liabilities shall not be lower than the amount specified by the Insurance Commission, otherwise it must take measures to fill the gap in accordance with the latter's requirement.[73]

4.3.2 *Prevention of risk concentration*

Since insurance is a business that accepts risk transferred from others, the prevention of risk concentration is a big issue in the supervision of insurance institutions. In this respect, the Insurance Law provides that the liability borne by an insurance company for each risk unit – that is, the liability arising from the maximum possible loss caused by the occurrence of a single insured event – may not exceed 10% of the combined total of its paid-in capital and accumulated funds; any excess shall be reinsured.[74] Arguably, this restriction on accepting risk from a single risk unit is still useful even after an official recognition of financial conglomerates in the possible near future.

4.3.3 *Investment in banks and other financial institutions*

As mentioned above, the original Insurance Law of 1995 firmly stuck to the principle of 'separated operation'. A securities company may only invest its funds in bank deposits, government bonds and financial bonds, and other instruments as specified by the State Council, and may not use its funds to set up securities firms or enterprises other than insurance companies.[75] This limitation, however, was substantially relaxed when the Insurance Commission promulgated the Interim Measures for the Administration of the Investment in Stocks by Insurance Institutions (*Baoxian Jigou Touzizhe Gupiao Touzi Guanli Zanxing Banfa*, herein 'Interim Stock Investment Measures') in conjunction with the Securities Commission in 2004 and the Interim Measures for the Administration of the Investment in Bonds by Insurance Institutions (*Baoxian Jigou Touzizhe Zhaiquan Touzi Guanli Zanxing Banfa*) in 2005. Without going into detail, the aggregate effect of those two documents was to permit insurance institutions to invest in listed stocks, convertible bonds, corporate bonds and other stipulated instruments by means of, *inter alia*,

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[71] Ibid., Art. 8.
[72] Ibid., Arts. 67 and 69.
[73] Ibid., Art. 101.
[74] Ibid., Art. 103.
[75] Insurance Law (1995), Art. 6.

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investment-linked insurance products and universal insurance products, within the various specified investment percentages.

A further breakthrough came in 2006 when the Insurance Commission issued the Notice Regarding Equity Investment in Commercial Banks by Insurance Institutions (*Guanyu Baoxian Jigou Touzi Shangye Yinhang Guquan De Tongzhi*, herein 'Bank Investment Notice'). This document broadly authorised insurance institutions to make equity investments in unlisted commercial banks such as SOCBs, joint-stock commercial banks and urban cooperative commercial banks.[76] Based on whether the total amount of investment reaches 5% and on whether it reaches 10% percent of the bank's equity capital, such equity investment is categorically divided into ordinary investment (less than 5%) and material investment (5% or more), and material investment is further divided into participation-type material investment (5% to 10%) and other material investment (10% or more).[77]

Various investment percentages have been set on the basis of this trichotomy: the aggregate balance of ordinary investment and participation-type material investment of an insurance institution may not exceed 3% of its total assets at the end of the previous year, whereas the balance of ordinary investment in a single bank may not exceed 1% of its total assets at the end of the previous year; the balance of other material investment needs to be examined and approved by the Insurance Commission, whereby the balance of material investment using the corporate capital funds may not exceed 40% of the paid-in capital minus accumulated losses of that institution at the end of the previous year.[78]

The Bank Investment Notice removed the investment restriction on insurance companies, giving them much more freedom, and they enthusiastically made use of this regulatory pass to acquire unlisted commercial banks. The well-known acquisition of the controlling shares of SCCB by the Ping An Group in 2006, as mentioned earlier in section 3.2, is but one example.

4.3.4 *Latest revision of the Insurance Law*

The Insurance Law as revised in 2009 incorporates the aforementioned development and specifies in a more systematic way a rather broad scope of investment for securities companies. Now an insurance company can use its funds to make bank deposits, buy or sell securities (bonds, stock, units of securities investment funds, etc.), invest in real estate and engage in other business as stipulated by the State Council. The Insurance Commission is required to make specific rules for the use of those funds.[79] The original clause barring insurance companies from setting up securities firms or other non-insurance enterprises has simply been removed. In

[76] Bank Investment Notice, Art. 1.
[77] Ibid., Arts. 2 and 6.
[78] Ibid., Art. 3.
[79] Insurance Law (2009), Art. 106.

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addition, upon approval by the Insurance Commission in conjunction with the Securities Commission, insurance companies may establish so-called 'insurance asset management companies' to manage their assets. Such asset management companies are allowed to engage in securities investment activities in accordance with the Securities Law and other relevant laws and regulations.[80]

In sum, insurance laws and regulations now seem to be more open and liberal with respect to cross-sectoral operation and investment compared to their banking and securities counterparts. This is largely due to the aforementioned development in recent years. Without considering other factors, this might suggest that currently insurance companies are in a better position to evolve into financial conglomerates.

4.4 **Regulatory structure**

4.4.1 De facto *regulatory structure regarding financial conglomerates*

The current financial regulatory structure in China is largely based on the principle of 'separated operation, separated regulation' as crystallised since the mid-1990s with the enactment of major financial laws and the establishment of various sectoral regulatory agencies. Basically, under this structure, the Banking Commission (formerly the People's Bank) is responsible for the supervision of commercial banks and TICs, the Securities Commission for the supervision of securities firms and FMCs, and the Insurance Commission for the supervision of insurance institutions. A brief survey of the relevant laws and regulations has shown that, despite the actual existence of numerous financial conglomerates and the gradual removal of legal barriers to their formation and/or development, not much guidance is provided regarding their supervision, especially in terms of cooperation and/or coordination between relevant sectoral regulators.

The terms 'financial conglomerates' or 'financial holding company' do not appear anywhere in the major financial laws or administrative regulations; nor does their supervision. The most pertinent provisions are perhaps those few found in the Banking Regulation Law and the Central Bank Law. More specifically, Article 6 of the Banking Regulation Law and Article 35 of the Central Bank Law require the Banking Commission and the People's Bank to establish a mechanism for sharing regulatory information between themselves and with other financial regulators, while Article 9 of the Central Bank Law authorises the State Council to establish a coordination mechanism for financial regulation and formulate the specific related rules.[81] A similar provision is found in the newly revised Insurance Law, which

[80] Ibid., Art. 107.

[81] In addition, there are a number of other specific provisions regarding the cooperation between the Banking Commission and the People's Bank on such matters as examination and inspection, payment and settlement, and systemic control and disposal. See Central Bank Law, Arts. 27, 33 and 35, and Banking Regulation Law, Arts. 6, 26, 29 and 28(2).

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requires the Insurance Commission to set up a regulatory information-sharing mechanism with the People's Bank and other financial regulators.[82] At the administration regulation level, Article 7 of the Regulation on the Supervision and Administration of Securities Companies (*Zhengquan Gongsi Jiandu Guanli Tiaoli*) promulgated by the State Council in 2008 also mandates that the Securities Commission, the People's Bank and other financial regulators establish an information-sharing mechanism for the regulation of securities companies.

4.4.2 *The Joint Conference and its Memorandum*

A legally binding official regulatory coordination mechanism, however, remains on paper. A regulatory coordination mechanism with respect to financial conglomerates or, more broadly, to cross-sectoral financial operations has so far been limited to an informal, occasional Joint Conference on Financial Regulation (herein 'Joint Conference'). In 2000, the People's Bank, the Securities Commission and the Banking Commission initiated the Joint Conference with the intent to bring the functions of the financial regulators into full play, share regulatory information and solve problems related to policy coordination in a timely manner. The Banking Commission, after its establishment in 2003, replaced the People's Bank as one of the three parties, and the three Commissions held their first Joint Conference in September the same year, which concluded with the Memorandum on Work Division and Cooperation in Financial Regulation (*Jinrong Jianguan Fengong Hezuo Beiwanglu*, herein 'Memo').

According to the Memo,

> the Joint Conference, consisting of the chairmen of the three agencies, shall be held quarterly. Chairmen or vice chairmen under the chairmen's authorisation shall join the conference, discussing and coordinating such matters as significant issues related to financial regulation, market feedback and performance evaluation on existing policies, and other things that call for negotiation, communication and exchange.[83]

More specifically, the Memo reaffirmed the separated regulation system based on the regulated institutions, and coined the term 'main-business regulation' ('*Zhujianguan Zhidu*') for FHCs:

> The principle of separated operation and separated regulation shall be adhered to in the regulation of financial holding companies. The regulation of the holding company shall, in accordance with the nature of the main business of the group,

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[82] Insurance Law (2009), Art. 158.
[83] Memo, Art. 15.

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> rest with the corresponding regulatory body; the relevant entities and businesses within the group shall be regulated separately in accordance with their nature.[84]

However, neither the Memo nor the Joint Conference itself has functioned as a legally binding arrangement. The Conference has discussed nothing more than general principles and has made few visible achievements except for the somewhat superficial Memo. In fact, since its second performance in March 2004, the Joint Conference has never been held again, highlighting the inherent limitation of such a loose, non-statutory mechanism.

5. INSUFFICIENCIES OF EXISTING LAWS AND REGULATIONS IN RELATION TO FINANCIAL CONGLOMERATES

Existing laws and regulations concerning the supervision of financial conglomerates are apparently insufficient. As stated above, current laws and regulations on financial supervision are generally distinguished in accordance with categories and segments of different financial services. Therefore, even though some provisions in certain laws and regulations may be helpful in dealing with some supervisory issues incurred by financial conglomerates, in an overall sense they fail to constitute a functioning and effective legal framework capable of providing clear guidance for the development and regulation of financial conglomerates.

5.1 **Absence of explicit legislation on financial conglomerates**

5.1.1 *Absence of explicit legislation and the* de facto *development of financial conglomerates*

Strictly speaking, even before the revision of the Commercial Bank Law, Securities Law and Insurance Law in 2003, 2005 and 2009 respectively, it was not expressly prohibited in China to establish financial conglomerates, at least in the form of FHCs. Specifically, Article 43 of the Commercial Bank Law (1995) prohibited commercial banks from engaging 'in trust investments and stock operations' or investing 'in non-banking financial institutions and enterprises', but did not prohibit other business entities from investing in and holding commercial banks. Similarly, Article 105 of the Insurance Law (1995) barred investment companies from establishing securities firms or non-insurance enterprises, but did not prohibit insurance companies from being invested in or controlled by other financial or non-financial enterprises. By the same token, Article 6 of the Securities Law (1998) only required that 'securities companies … be established separately from banks, trust

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[84] Ibid., Art. 8.

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companies and insurance companies', and different subsidiaries as independent legal persons under the same holding company seem to properly meet this requirement. Thus, at least with respect to FHCs, there has in fact never been a sweeping prohibition by the major financial laws.

Despite this fact and the scattered provisions in relevant laws and regulations enabling cross-sectoral operation and investment, not a single law has come into existence that explicitly authorises the establishment of financial conglomerates and specifies such key regulatory matters as the definition and determination of a financial conglomerate, the basic approach and structure of regulation, the scope and focus of regulation (e.g., capital adequacy, risk concentration, intra-group transactions, and internal control mechanisms) and the division and coordination of regulatory responsibilities. In the absence of such overarching legislation, these limited enabling provisions, scattered among different sectoral laws and regulations and administered by different sectoral regulators, cannot direct the regulation of financial conglomerates in a comprehensive and coherent way.

Thus, on the one hand, financial conglomerates have never been completely prohibited by law; on the other hand, there have been no explicit corresponding rules for their establishment and regulation. The result has been a disorderly development of financial conglomerates and regulatory loopholes with respect thereto. The rise and fall of the notorious Delong Group provides a vivid picture in this regard.

5.1.2 *Lessons from the Delong case*

Initially incorporated in the Xinjiang Uigur Autonomous Region and then headquartered in Shanghai, Delong's story started with three siblings starting an ambitious grass roots entrepreneurial business that engaged in maverick business expansion and disastrous stock speculations. Market manipulation and loss created a desperate desire to control and exploit financial institutions for its subsidiaries' parasitic survival. Thus, Delong strived to control TICs, securities firms and local banks through acquisition, and eventually became a *de facto* private financial conglomerate. Subsequent investigation discovered that Delong proved to be a huge financial black hole and had accumulated more than two billion US dollars in unpayable losses. When things went sour and Delong's controlled stock prices nosedived in 2004, twenty billion RMB in market value evaporated within ten days. On 29 April 2006, the head of Delong – Mr Tang Wanxin – stood trial on charges of illegal public deposit taking and manipulating stock prices. He was convicted and sentenced to eight years' imprisonment and a 400,000 RMB personal criminal fine. As for the Delong Group, a USD 1.3 billion company criminal fine was imposed, which analysts deemed as most likely uncollectable.[85]

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[85] See Guo Li, 'Financial Conglomerates in China: Legality, Model and Concerns', Peking University Law School (2008) (unpublished conference paper, on file with the author).

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Strictly speaking, Delong is at best a quasi-financial conglomerate, or an industrial-commercial group with financial elements. Delong had more than 200 affiliated or controlled enterprises under its flag. Apart from industrial-commercial enterprises, they included such financial institutions as commercial banks, securities firms, TICs and financial lease companies, covering almost all financial business areas in China. Integration of financial capital and industrial-commercial capital as well as capital integration among different financial institutions were main factors contributing to the rapid growth of the group.[86] Not only did Delong wantonly engage, through its complex organisational structure, in affiliated transactions to exaggerate assets, but it also obtained snowballing bank credit through a circle of borrowing, acquisition, stock pledge, more borrowing and more acquisitions,[87] significantly challenging the then existing prohibition on the flow of bank funds into stock market against regulations.[88] When the capital chain broke and the 'Delong Legend' proved an illusion, creditors, including such major commercial banks as the Bank of Communications, were tainted by the huge risk loss suffered by Delong.

The Delong story fully demonstrated the insufficiencies of the existing legal and regulatory framework with respect to financial conglomerates: key rules had not been put in place in terms of division of regulatory responsibilities, qualification and licence for market admission, limitation on the affiliation between financial and industrial-commercial enterprises, and control over intra-group affiliated transactions, thus providing inadequate guidance for regulatory practice and leaving loopholes for market participants. Furthermore, the absence of information-sharing and emergency coordination mechanisms prevented group risks from being timely identified, assessed and addressed, resulting in further losses.

5.2 Rigid adherence to institutional regulation

5.2.1 *The concept of institutional regulation and its limitation*

Current financial regulation in China is almost completely based on institutions. Institutional regulation, or entity regulation, is a regulatory approach whereby the division of regulatory responsibilities is based on the nature of financial institutions, i.e., banking regulators are in charge of the regulations of banks, securities regulators of those regarding securities firms, and insurance regulators of those relating to insurance companies. Historically, it was the main approach to financial regulation.

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[86] See Zhou Zhihong, 'Cong Delong Fengxian Kan Woguo De Jinrong Jianguan' [China's Financial Regulation Viewed from the Perspective of Delong Risks], 7 *Zhongguo Chengshi Jinrong* [China Urban Finance] (2007) p. 22.

[87] See Bu Yongxiang, 'Delong Weiji Zhangxian Fenye Jianguan Quexian' [The Delong Crisis Highlights the Defects in the Separated Regulation], *Zhengquan Shibao* [Securities Times], 30 June 2004, p. 2.

[88] See *supra* nn. 65-66 and accompanying text.

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Under this approach, all regulatory matters related to a particular type of financial institution are addressed by one and the same regulatory agency, no matter what financial activities are involved.

There is no denial that a case can be made for the institutional approach: on the one hand, in a traditional context where financial institutions had a comparatively narrow and differentiated scope of business unlikely to overlap, it did not make much difference whether the regulation was based on institutions or on their businesses (i.e., the functional approach discussed below); on the other hand, the idea of institutional regulation is essential for prudential supervision, since the latter requires examination of the risks and solvency of an institution as a whole, and this requirement cannot be satisfactorily met by a business-oriented approach. However, with the diversification of the business of financial institutions, for example, through the establishment of financial conglomerates, the institutional approach has gradually proved inadaptable. Most notably, banks, securities companies and insurance companies often provide functionally similar financial products which nonetheless are regulated by different regulatory agencies according to perhaps different criteria, which is contrary to the idea of fair completion.

In the United States, for example, the open-end money market mutual funds (herein 'MMFs') which invest in short-term, highly liquid securities, allow investors to redeem their funds at any time and provide certain checking account services, have constituted a competing alternative to the demand deposit accounts of commercial banks. However, before 1986, depositary institutions (under the supervision of the Federal Reserve and the Office of the Comptroller of the Currency) were prohibited from raising interest rates beyond the ceiling imposed by Federal Reserve Regulation D, whereas the functionally similar MMFs provided by investment banks under the regulation of the Securities and Exchange Commission (SEC) were not subject to this limitation. It was argued that such regulatory difference led to the MMFs' competitive advantage and was a major cause of the latter's success.[89]

5.2.2 *Lessons from the 'wealth management' business*

The emerging wealth management business in China has similarly challenged the traditional wisdom underlying institutional regulation. So-called 'wealth management' ('*Geren Licai*') is a rather broad and ambiguous term, which covers various financial services including money market investment services provided by commercial banks, directed or aggregated asset management services provided by securities firms, money trust services provided by TICs, entrusted asset management services provided by FMCs, and investment-linked insurance services provided by

[89] See Timothy A. Canova, 'The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership', 60 *Brooklyn Law Review* (1995) p. 1295, at p. 1320.

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insurance companies.[90] Various wealth management products provided by different financial institutions constitute an essential part of financial innovation in China but at the same time serve as a major contributor to the regulatory chaos. Such products cover a wide range of financial services with different fashionable names, which differ from the traditional distinguishable core business of financial institutions and have much in common. Although so far there has been no formal clarification as to their legal nature, most of them resemble trust investment, share similar functions and operational mechanisms and require consistent regulation.[91] Due to the inflexible adherence to the institutional approach, however, these functionally similar products are subject to supervision by different regulatory agencies, which often hold different ideas and apply different standards with respect to such material matters as the threshold amount, the time limit of investment and the question of whether the principal is guaranteed against loss, of whether minimum proceeds may be promised and of whether the investment in question is transferable and tradable.[92] This has not only impeded the smooth development of relevant business operations but has also undermined regulatory efficiency and investor protection.

5.3 Lack of meaningful regulatory coordination

The development of financial conglomerates can substantially intensify regulatory conflict among various sectoral regulators. Regulatory conflict, which is inherent in any regulatory regime, roughly means the conflict of regulatory authorities/functions among different regulators due to, *inter alia*, an unclear division of regulatory responsibilities and/or financial innovations outpacing legal adjustment. It may take the form of an active conflict where different regulatory agencies struggle to regulate and cause regulatory overlap (as seen in the wealth management case), or it may present itself as a passive conflict where the regulators for some reason all refrain from or omit regulation, which results in regulatory loopholes (as demonstrated by the Delong event).

A well-designed coordination mechanism helps to prevent or solve, at least partially, regulatory conflict. Such a mechanism, however, is still absent in China. Although some sectoral laws have required the sectoral regulators to cooperate with

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[90] For a more detailed discussion of the wealth management services provided by financial institutions in China, see Guo Li, *Zhongguo YinhangYe Chuangxin Yu Fazhan De Falü Sikao* [Legal Thoughts on the Innovation and Development of China's Banking Industry] (Peking University Press 2006), at pp. 55-72.

[91] See Xia Bin, 'Dui Woguo Jinrong Jigou Zonghe Jingying De Jianguan Jianyi' [Suggestions about the Regulation of the Integrated Operation by the Financial Institutions in China], *Xinlang Caijing* [Sina Finance], 12 January 2006, available at: <http://finance.sina.com.cn/economist/jingjixueren/20060112/09322269768.shtml>, last visited on 3 December 2010.

[92] See Zou Minsheng and Cheng Yong, 'Xiabin Zhiyan Jinrong Jianguan Cun Bada Ruanlei' [Report: Xia stated frankly that Eight Weak Points Exist in Financial Regulation], *Shanghai Zhengquan Bao* [Shanghai Securities News], 4 November 2005, A2.

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one another and set up appropriate information-sharing and coordination mechanisms, such a requirement remains on paper. The seemingly fashionable Joint Conference and its Memo do not provide much assistance, due to their informal, irregular and non-binding nature. In fact, as mentioned above, the Joint Conference itself is yet to be revived.

Furthermore, an essential element of effective regulatory coordination is missing from the hibernating Joint Conference and from the authorising provisions in the relevant sectoral laws, i.e., the appointment of a coordinator or overall regulator. According to the main-business regulation approach as stated in the Memo, an FHC is regulated in accordance with the nature of its 'main business' by the corresponding sectoral regulator, while its financial subsidiaries are regulated separately in accordance with their respective nature. However, it is only natural to ask the question: what if the sectoral regulators cannot agree on the nature of a conglomerate's main business? Or what if the approach adopted by the group-level regulator determined on a case-by-case basis happens to be inconsistent with that of a sectoral regulator? In fact, due to the lack of further clarification and guidance, in practice, the regulation is more or less based on the tacit principle of pre-emption: the regulator responsible for the supervision of a parent company also exercises supervision over its subsidiaries. According to the author, it is a pity that the People's Bank simply withdrew from the Joint Conference in 2003 with the establishment of the Banking Commission, without exploring the possibility of it staying as an overarching coordinator. This has rendered the three Commissions with equal powers and authorities practically unable to function in a coordinated way.

6. THOUGHTS AND SUGGESTIONS BASED ON US AND EU EXPERIENCES

6.1 **The need for a specific law on financial conglomerates**

6.1.1 *The EU Financial Conglomerate Directive*

As can be seen above, the current disorderly development of financial conglomerates in China and the corresponding unsatisfactory regulation is to a great extent due to the absence of a specific law on financial conglomerates. Such a law may, among other things, explicitly authorise the establishment of financial conglomerates and specify such key regulatory matters as the definition and determination of a financial conglomerate, the basic approach and structure of regulation, the scope and focus of regulation, and the division and coordination of regulatory responsibilities. In this respect, a vivid illustration is provided by the Directive of the European Union (EU) on the supervision of financial conglomerates adopted in 2002.[93]

[93] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment

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The principal reason for the Directive was the need to keep up with the accelerating pace of consolidation in the financial industry as indicated by the rapid development of financial conglomerates. Noting that laws and regulations dealing with different financial sectors were not able to deal with these developments and that such laws have traditionally adopted different approaches with different definitions of capital, different types of risks and different capital requirements,[94] the Directive is intended to ensure the stability of the European financial market, establish common prudential standards for the supervision of such financial groups throughout Europe, and introduce level playing fields and legal certainty between financial institutions.[95]

6.1.2 *The determination of a financial conglomerate*

Basically, for the purpose of determining a financial conglomerate, the Supplementary Supervision Directive distinguishes between groups that are headed by an EU-regulated entity and those that are not (i.e., those that are run either by a non-EU regulated entity or by a non-regulated entity).[96] In both cases, the group needs to have at least one entity within the insurance sector and one within the banking or investment services sector,[97] and the consolidated and/or aggregated activities of the entities within the insurance sector and those of the entities within the banking and investment services sectors both need to be significant.[98] Then, in order to be 'significant', for each financial sector the average of the ratio of the balance sheet total of that sector to the balance sheet total of the financial entities in the group and the ratio of the solvency requirements of the same sector to the total solvency requirements of the financial entities in the group should exceed 10%.[99] Cross-sectoral activities are presumed to be significant, however, if the balance sheet total of the smallest financial sector in the group exceeds EUR 6 billion.[100] In

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firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council, *OJ* 2003 L 35/1(herein 'Supplementary Supervision Directive' or 'Directive').

94 See Michael Gruson, 'Supervision of Financial Conglomerates in the European Union', available at: <https://www.imf.org/external/np/leg/sem/2004/cdmfl/eng/gruson.pdf>, last visited on 3 December 2010, at p. 1.

95 See the Explanatory Memorandum to the Proposed Supplementary Supervision Directive (24 April 2001), *OJ* 2001 C 213 E/227, at p. 228.

96 'Regulated entity' means a credit institution, an insurance undertaking or an investment firm. See Supplementary Supervision Directive, Art. 2(4).

97 Ibid., Art. 2(14)(d).

98 Ibid., Art. 2 (14)(e).

99 Ibid., Art. 3(2). Here, banking and investment services are treated as one sector, which means that both the insurance activities and the banking and investment activities (taken together) should be significant. Ibid.

100 Ibid., Art. 3(3).

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addition, a group that is not headed by an EU-regulated entity only qualifies as a financial conglomerate if its activities mainly occur in the financial sector, i.e., based on the balance sheets, the financial sector entities must represent at least 40 percent of the group.[101] On the other hand, a group headed by an EU-regulated entity qualifies as a financial conglomerate even though its activities do not mainly occur in the financial sector.

6.1.3 *Supplementary supervision and the mandatory coordination system*

The supervision imposed by the Directive is called 'supplementary supervision' because it does not replace the existing solo supervision of individually regulated entities or the sectoral supervision of groups that operate in one sector of the financial industry, but rather introduces additional supplementary supervision of the regulated entities in those groups that straddle more than one financial sector, i.e., financial conglomerates. Without going into detail, the supplementary supervision applies to certain regulated entities in a financial conglomerate[102] and such entities have to meet the relevant regulatory requirements at the conglomerate level. As specified in Articles 6 through 9 of the Directive, the supplementary supervision mainly concerns capital adequacy, risk concentration, intra-group transactions, and internal control mechanisms and risk management processes, which are also the main problem areas related to supervision of financial conglomerates worldwide.

What is particularly pertinent here is that the Supplementary Supervision Directive introduces a mandatory coordination mechanism. According to the Directive, a single coordinator responsible for the coordination and exercise of supplementary supervision should be appointed from among the competent authorities, i.e., the sectoral regulators.[103] Basically, if a financial conglomerate is headed by a regulated entity, the coordinator should be the sectoral regulator which has authorised that regulated entity;[104] or else different criteria apply depending on the various circumstances as specified in Article 10(2)(b) of the Directive. In either case, however, the relevant competent authorities may by common agreement waive the abovementioned criteria and appoint a different competent authority as coordinator, provided that they give the conglomerate in question an opportunity to state in advance its opinion on that decision.[105] The tasks of the coordinator are specified in the Directive,[106] and the coordinator and the other relevant competent

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[101] Ibid., Arts. 2(14)(c) and 3(1).

[102] Such entities are specified in Article 5(2) of the Supplementary Supervision Directive.

[103] Supplementary Supervision Directive, Art. 10(1).

[104] Ibid., Art. 10(2)(a).

[105] Ibid., Art. 10(3).

[106] Such tasks include: (1) coordination of the gathering and dissemination of relevant or essential information in going concern and emergency situations, including the dissemination of information which is of importance for a competent authority's supervisory task under sectoral

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authorities are required to have coordination arrangements in place, which may entrust additional tasks to the coordinator and specify the procedures for the decision-making process among the relevant competent authorities.[107]

Admittedly, circumstances surrounding the adoption of the Supplementary Supervision Directive were not the same as those now existing in China, and the focus and concerns of the EU legislature were more or less different from those of its Chinese counterpart. Nevertheless, the merit of having a specific law on financial conglomerates that in a comprehensive and consistent way sets out the relevant criteria and rules for their supervision is worthy of serious consideration.

6.2 From institutional regulation to functional regulation

6.2.1 *The concept of functional regulation*

As is illustrated by the regulatory chaos with respect to wealth management services, rigid institutional regulation cannot satisfactorily meet the challenge raised by diversified, cross-sectoral operations. It is at this point that functional regulation comes into play. Functional regulation rests on the principle that like functions should be regulated alike, regardless of the type of entity performing such functions.[108] In the financial regulation arena, the idea of functional regulation first appeared in the United States in the early 1980s, when the United States Department of the Treasury suggested that all the securities business of commercial banks be carried out through independent subsidiaries and be regulated by the SEC and the National Association of Securities Dealers, so as to prevent commercial banks from having unjustified competitive advantage over securities companies.[109] The SEC labelled such a regulatory arrangement as 'functional regulation' and voiced its consent and support. Subsequently, functional regulation became a consistent theme

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rules; (2) supervisory overview and assessment of the financial situation of a financial conglomerate; (3) assessment of compliance with the rules on capital adequacy and of risk concentration and intra-group transactions as set out in Articles 6, 7 and 8; (4) assessment of the financial conglomerate's structure, organisation and internal control system as set out in Article 9; (5) planning and coordination of supervisory activities in going concern as well as in emergency situations, in cooperation with the relevant competent authorities involved; (6) other tasks, measures and decisions assigned to the coordinator by the Directive or deriving from the application of the Directive. See Supplementary Supervision Directive, Art. 11(1).

[107] Ibid.

[108] See Melanie L. Fein, 'Functional Regulation: A Concept for Glass-Steagall Reform?', 2 *Stanford Journal of Law Business and Finance* (1995) p. 89.

[109] According to the Securities and Exchange Act of 1934, banks engaged in certain specified securities transactions allowed by the Act are not 'brokers' or 'dealers' within the meaning of the Act and therefore need not register with the SEC or comply with the regulatory requirements of the Act and the corresponding SEC rules. See the Securities and Exchange Act of 1934, §§ 3(a)(4)(B) and 3(a)(5)(B).

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of financial reform efforts in the United States for well over a decade and was finally adopted by the Gramm-Leach-Bliley Act (herein 'GLBA') enacted in 1999.[110] According to Mr James A. Leach, Chairman of the House Banking and Financial Services Committee and one of the three sponsors, the GLBA

> provides for functional regulation with state and federal bank regulators overseeing banking activities, state and federal securities regulators governing securities activities, and the state insurance commissioners looking over the operations of insurance companies and sales … [p]uts the most experienced regulators in charge of overseeing the operations of the financial firms that they know best.[111]

Following the idea of functional regulation, the GLBA repealed the bank exemption from federal securities laws, thereby requiring that most of the securities activities of commercial banks be transferred to a separate affiliate or subsidiary and be regulated by the SEC.[112] Section 205 of the GLBA, which provides for the regulation of the so-called 'new hybrid product',[113] is specially designed to solve potential regulatory conflict resulting from financial innovation: the SEC has primary regulatory authority over new hybrid products, but is required to consult with and seek the concurrence of the Federal Reserve before imposing broker-dealer registration requirements in connection with such hybrid products.[114] In addition, the GLBA

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[110] In fact, Title 2 of the GLBA is called 'Functional Regulation'. See GLBA, 113 Stat. 1338 (1999), Title 2.

[111] James A. Leach, 'Modernization of Financial Institutions', 25 *Iowa Journal of Corporation Law* (2000) p. 681, at p. 688.

[112] Ibid., at p. 686.

[113] The term 'new hybrid product' means a product that: (i) was not subjected to regulation by the SEC as a security prior to the date of the enactment of the GLBA; (ii) is not an identified banking product as such term is defined in Section 206; and (iii) is not an equity swap within the meaning of Section 206(a)(6). See GLBA, § 205(6)(A). Notably, this definition does not mention the possibility of the product being an insurance product, nor does Section 205 require the SEC to consult with the state insurance regulators before issuing rules governing hybrid products that may be combinations of insurance and securities products. Section 104 of the GLBA, however, did reaffirm that the states would retain control over the regulation of insurance products and services. See GLBA, § 104(b).

[114] GLBA, § 205(1). If the Federal Reserve disagrees with the SEC's determination that the product is a security and subject to regulation by the SEC, the Federal Reserve may have the U.S. Court of Appeals for the District of Columbia review the final regulation adopted by the SEC, provided that the Federal Reserve files, not later than 60 days after the date of publication of the final regulation, a petition with the court requesting that the regulation be set aside. Ibid., § 205(5)(A). The Court of Appeals must base its determination on whether to set aside the regulation on whether the court finds that the product is a new hybrid product, that the new product is a security, and that imposing a requirement to register as a broker or dealer for banks buying or selling the product is 'appropriate in light of the history, purpose, and extent of regulation under the Federal securities laws and under the Federal banking laws' without giving deference to either the SEC or the Federal Reserve. Ibid., § 205(5)(D).

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obligates any functional regulator to share information with and accept existing reports submitted to other regulators.[115]

6.2.2 *Role of the umbrella regulator*

As noted, functional regulation has a remarkable advantage over institutional regulation in adapting to the business diversification and cross-sectoral operations of financial institutions. Such an approach cannot, however, fully meet the requirement of prudential supervision concerning the overall risks and solvency of a given institution or group of institutions. Accordingly, the so-called 'lead regulation' appeared in England in the 1980s. Originally designed for banks engaged in investment banking business, this approach roughly means that the regulator in charge of the regulation of the main business of a financial conglomerate shall serve as the 'lead regulator', responsible for the overall risk supervision of the conglomerate and the coordination of the information sharing and cooperation among the various functional regulators.[116] The informal 'main-business regulation' embodied in the Memo is essentially a kind of lead regulation as well, albeit not fully based on the idea of functional regulation.[117]

A similar but enhanced approach is the so-called 'umbrella regulation' set out by the GLBA. Different from the lead regulation where the lead regulator is determined *ad hoc* based on the main business of a given conglomerate, the GLBA specifically designated the Federal Reserve as the overall regulator, or umbrella regulator, for FHCs. According to the GLBA, the Federal Reserve has statutory authority over FHCs and their subsidiaries, is authorised to examine an FHC or any of its subsidiaries in respect of financial conditions, risk controlling and compliance, and may require the submission of relevant reports as deemed necessary.[118] The umbrella regulation of the Federal Reserve, however, is restricted by the functional regulation of other regulators: the former should endeavour to limit the focus and scope of any examination to the holding company,[119] and may examine a subsidiary functionally regulated by another regulator only under specified exceptional circumstances;[120] in

[115] GLBA, §§ 204, 231(a)(3)(B).

[116] England's main purpose to establish such a mechanism at that time was to coordinate the regulatory efforts of the Bank of England, the Securities and Investment Bureau (predecessor of the current Financial Services Authority) and the relevant self-regulatory organisations in the backdrop of the diversification of the business of banks. See George A. Walker, 'Conglomerate Law and International Financial Market Supervision', 17 *Annual Review of Banking Law* (1998) p. 287, at p. 306.

[117] See *supra* nn. 82-83 and accompanying text.

[118] GLBA, § 111(1)(A) and (2)(A).

[119] Ibid., § 111(2)(C)(iii).

[120] Such circumstances include: (i) the Federal Reserve has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution; (ii) the Federal Reserve reasonably determines, after reviewing relevant reports, that

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addition, the Federal Reserve should pay deference to the examinations by other regulators, rely to the fullest extent possible on the reports of examinations made by such other regulators, and accept existing reports submitted by an FHC or its subsidiaries to such other regulators.[121]

6.2.3 *The People's Bank as the umbrella regulator*

Arguably, a phase-in of functional regulation, with an umbrella regulator put in place,[122] could to a great extent organise the regulatory chaos in relation to cross-sectoral operations. For example, with respect to the troublesome wealth management services, the People's Bank should, in conjunction with the three Commissions, formulate guiding principles and rules for their regulation based on their essential function(s) (e.g., trust investment) and submit such principles and rules to the State Council for approval and promulgation in the form of an administrative regulation. Then, the relevant regulatory agencies can formulate more detailed implementing rules within their competence. In case of any possible divergence or conflict among the regulators in the process of implementation, negotiation shall first be tried; if no agreement is reached, they may resort to a possible dispute resolution mechanism within the statutory coordination structure to be further discussed below, whereby the dispute is submitted by the People's Bank to the State Council for a final decision. Similarly, future financial innovation should also be coordinately regulated on the basis of the functional principle: any regulatory agency, when adopting rules on new financial products likely to trigger the jurisdiction of another agency, should consult with that agency and the People's Bank in advance for agreement. Again, if they cannot reach agreement, the dispute resolution mechanism may be resorted to.

It is gratifying that elements of functional regulation are already seen in some existing laws and regulations, albeit in a rudimentary form. The Commercial Bank Law, for example, states that commercial banks are generally subject to regulation by the Securities Commission, but if there are *laws* providing that their relevant business activities shall be regulated by other agencies, such provisions shall

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examination of the subsidiary is necessary to adequately inform it of the systems for monitoring and controlling the financial and operational risks within the holding company system that may pose a threat to the safety and soundness of any depository institution subsidiary of such holding company; (iii) based on reports and other available information, the Federal Reserve has reasonable cause to believe that a subsidiary is not in compliance with the GLBA or any other federal law that it has specific jurisdiction to enforce against such subsidiary, including provisions relating to transactions with an affiliated depository institution, and the Federal Reserve cannot make such determination through examination of the affiliated depository institution or the holding company. Ibid., § 111(2)(B) and (2)(A)(ii)(II).

[121] Ibid., § 111(1)(B), and 2(D)-(E).

[122] The possibility of having an umbrella regulator is further explored in section 6.3 below in the discussion of the statutory mechanism for regulatory coordination.

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prevail.[123] Similarly, the Interim Stock Investment Measures stipulate that the Insurance Commission and the Securities Commission, in accordance with their respective responsibilities, shall carry out supervisions and examinations of the stock investment business of insurance institutions.[124] What is needed now, according to the author, is a clearer and more systematic introduction of this approach as discussed above.

6.3 Towards better regulatory coordination

6.3.1 *Formal coordination mechanism needed*

In terms of reinforcing the coordination among different sectoral regulators, the first priority should be the establishment of a formal coordination mechanism based on functional regulation, with a coordinator or umbrella supervisor responsible for the overall supervision of a financial conglomerate. It seems to the author that at present no other agency is more qualified for the role of umbrella supervisor than the People's Bank. The necessity and significance of the central bank's presence in financial regulation is beyond question – even in those countries that have adopted integrated regulation, central banks continue to play a key role in issuing and amending relevant prudential regulations, authorising or revoking licences to financial intermediaries, and establishing other important laws for the entire financial system.[125]

As has been argued by the author elsewhere, the People's Bank needs to share certain financial regulatory responsibilities so as to take precautions against and reduce systemic risks, effectively perform the lender-of-last-resort function, and make use of comparative advantage to reduce regulatory cost.[126] Moreover, there are other reasons that are more practical: on the one hand, the Banking Commission, the Securities Commission and the Insurance Commission have their respective 'turfs' of regulation and lack the apparent impartiality of the People's Bank; on the other hand, the People's Bank used to be the sole financial regulator from which the regulatory powers of all three Commissions have derived, which has left the People's Bank with an influence unparalleled by any of the three successors. It is argued, therefore, that the State Council should, under Article 9 of the Central Bank Law and in the form of an administrative regulation, make clear the role of the People's Bank as overarching supervisor and establish a permanent coordination mechanism led by it.

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123 Commercial Bank Law, Art. 10.

124 Interim Stock Investment Measures, Arts. 4 and 53.

125 See Martínez and Rose, *supra* n. 5, at p. 12.

126 See Fan Liao and Siman Wang, *Luelun Renmin Yinhang Yu Yinjianhui Jianguan Zhineng De Huafen Yu Xietiao* [On the Division and Coordination of Financial Regulatory Powers between the People's Bank and the Banking Commission], 8 *Jinrong Fayuan* [Financial Law Forum] (2003), at pp. 53-54.

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Based on a specific law on financial conglomerates and guaranteed by an effective formal coordination mechanism, a reasonable division of supervisory responsibilities is expected. Such a division should reflect the difference in organisational structure between financial conglomerates. Specifically, in the case of an FHC, i.e., a financial conglomerate where a pure holding company controls different financial institutions, the People's Bank as the umbrella regulator should be responsible for the conglomerate's overall regulation, while the various financial subsidiaries are subject to regulation by the corresponding functional regulators. As to a financial conglomerate where a financial institution serves as the holding company (e.g., bank-parent model), the holding company should be regulated by its functional regulator (e.g., Banking Commission), while the various financial subsidiaries are, again, subject to regulation by the other corresponding functional regulators. When it comes to mixed conglomerates, it might be necessary to require such organisations to be 'financial in nature' to qualify as a financial conglomerate, by specifying the maximum percentage of non-financial activities/assets in a financial conglomerate and imposing other necessary limitations on its engagement in non-financial activities. As to an existing mixed conglomerate that cannot be said to be financial in nature, work needs to be done to either divest some of its non-financial activities in order to make it qualified, or to establish a separate holding company and transfer the ownership of the shares of its financial subsidiaries to the latter. The new financial conglomerate formed either way should then be coordinately regulated in accordance with its organisational model and on the basis of the functional principle.

6.3.2 *Latest development in practice*

The latest development has largely attested to this argument. In January 2007, a group of Chinese top-level government officials gathered in Beijing and held the Third National Financial Work Conference chaired by Premier Wen Jiabao. This Conference decided to postpone any plan to merge the currently separate financial regulatory bodies into one single agency. Rather, the People's Bank and the three regulatory commissions would continue to operate separately, and work on improving their effectiveness and professional capability, as well as on enhancing their collaboration. Later, the new Provisions on the Main Responsibilities, Organisational Structure and Personnel Quota of the People's Bank of China (*Zhongguo Renmin Yinhang Zhuyao Zhize Neishe Jigou He Renyuan Bianzhi Guiding*, herein 'People's Bank Provisions'), approved by the State Council in July 2008, further highlighted the role of the People's Bank in the coordination mechanism. Section 5(4) of the People's Bank Provisions states:

> Under the leadership of the State Council, the People's Bank shall, *in conjunction with* the Banking Commission, the Securities Commission and the Insurance Commission, establish a coordination mechanism for financial regulation in the

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> form of an inter-agency joint conference, so as to enhance the coordination between monetary policy and regulatory policy as well as between regulatory policies and rules, establish a financial information-sharing system, take precautions against and reduce financial risks, and maintain national financial safety. Significant issues shall be submitted to the State Council for decision. [emphasis added]

According to a government source, 'in conjunction with' here essentially means 'take the lead'. The People's Bank reportedly would join the three Commissions' Joint Conference to be revived and held regularly.[127] This would definitely mark a significant step in the right direction. According to the author, the next step should be, first, to set up a shared secretariat to provide the necessary research and logistics support, and then to transform the to-be-revived Joint Conference into a more substantive mechanism such as a coordination committee for financial supervision. So far, the formal coordination mechanism mandated by the People's Bank Provisions has not been put in place, partly due to the unexpected global financial crisis; however, in the author's view, this is only a matter of time.

6.4 **Is single regulation a must?**

6.4.1 *Single regulation as exemplified by the UK FSA*

To many in China, an integrated regulation system where all regulatory agencies are merged into one seems to be a natural reaction to the development of financial conglomerates. In fact, many countries have indeed chosen this path in recent years. According to statistics, by the end of 2005, at least 50 countries had adopted the model of integrated regulation either by establishing a single supervisor for their entire financial sector or by centralising into one agency the powers to supervise at least two of their main financial intermediaries (such as banking with insurance, banking with securities or securities with insurance).[128] Although integrated regulation appeared as early as in the 1980s in the northern European countries,[129] the

[127] See Wang Jing, 'Jinrong Jianguan Yanghang "Qian" Deliao "Tou" Ma?' [Report: Is the Central Bank Able to 'Take' the 'Lead' in Financial Regulation?], 19 August 2008, available at: <http://www.caijing.com.cn/2008-08-19/110006647.html>, last visited on 3 December 2010.

[128] See Martínez and Rose, *supra* n. 5, at p. 2; Elizabeth F. Brown, 'Why the United States Needs a Single Financial Services Agency', 14 *University of Miami Business Law Review* (2005) p. 1, at pp. 92-93.

[129] Norway established an independent unified banking and insurance regulator in 1986, Denmark in 1988 and Sweden in 1991. Finland followed in 1993, but linked its single regulator to the central bank, the Bank of Finland. Notably, the Nordic countries have small and consolidated financial markets, have some prior experience with regulatory consolidation, and suffered a series of financial crises in the 1980s and early 1990s. See, generally, Michael Taylor and Alex Fleming, 'Integrated Financial Supervision: Lessons of Northern European Experience', World Bank, September 1999.

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real catalyst of this far-reaching trend was the establishment of the Financial Services Authority (FSA) in the United Kingdom in 1997. The discussion below is mainly based on the single-regulator model as exemplified by the UK FSA.

Arguments for the single-regulator model include better monitoring of cross-sectoral risks, more effective regulation of financial conglomerates, minimisation of agency capture, better protection for consumers, reduction of regulatory cost, etc.[130] However, as one commentator has pointed out, for all of the main policy, institutional and operational arguments that can be mustered in favour of a single regulator, a corresponding countervailing number of disadvantages can be identified.[131] The author therefore does not attempt to compare the advantages and disadvantages of the single-regulator model one by one, but instead tries to observe whether such a model is a necessary or desirable choice for today's China.

6.4.2 *Why the FSA model is unfit for China*

To be sure, the FSA was largely tailored for such a highly developed and concentrated financial system as that of the UK and was not intended to become an 'international model'. As Mr Michael Foot, former managing director of FSA put it: 'We have never said that the UK model was one that other countries should follow. And we recognise that there are features of the UK (such as the fact that most of the financial service sector is concentrated in London) that has helped the creation of the FSA.'[132] Though, admittedly, the FSA is not a synonym of the single-regulator model or integrated regulation per se and other countries may make their own adjustments when adopting integrated regulation, some exterior preconditions for the single-regulator model to effectively function do exist. A study covering the financial regulation regime of 68 countries reveals that the level/possibility of concentration in the financial regulatory structure is positively related to the maturity of the institutional environment characterised by good governance, and negatively to market size and the participation of the central bank.[133] If reliable, this result seems to caution against China's adoption of integrated regulation.[134]

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[130] For more details, see Brown, *supra* n. 128, Part V (at pp. 74-87).

[131] See Joseph J. Norton, 'Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience – A Critical Reevaluation', 39 *International Lawyer* (2005) p. 15, text accompanying footnote 13.

[132] See 'FSA-UK Managing Director Shares His Views on Integrated Supervision and Deposit Protection', *PDIC Forum*, Vol. 2, No. 1, at p. 27, available at: <http://www.pdic.gov.ph/files/PDIC_Forum-June2004.pdf>, last visited on 3 December 2010.

[133] See Donato Masciandaro, 'Financial Supervision Architectures and the Role of Central Banks', 18 *The Transnational Lawyer* (2005) p. 351, at pp. 367-68.

[134] Interestingly enough, shortly after the Conservative Party regained power in the UK in May 2010, the new government announced in June that it planned to abolish the FSA by 2012, with its banking supervisory power transferred to a new Prudential Regulation Authority under the Bank of England, and consumer protection functions to be taken over by a new, independent Consumer

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More pertinently, as discussed above, if counted from the promulgation of the Commercial Bank Law in 1995, only fifteen years have passed since the finalisation of the current separated regulation regime, and only twelve or seven years if counted from the establishment of the Insurance Commission and promulgation of the Securities Law in 1998 or from the establishment of the Banking Commission in 2003. Arguably, the current regulatory regime is still at a rudimentary, experience-accumulating stage, with more time needed to better understand its advantages against disadvantages and benefits against costs. A fundamental change is thus inappropriate from the perspective of institutional stability and continuity. What should be done now is to sum up regulatory experiences and strengthen the existing structure, instead of rushing into the fashionable regulatory integration in the absence of sufficient analysis and experimentation.

Besides, in the view of the author, integrated regulation has two layers of meaning, i.e., consolidation of agencies and unification of rules. If there is only consolidation of agencies, the resulting integrated agency will not be essentially different from the umbrella structure based on functional regulation and cannot make the best of integrated regulation. However, unification of rules is much more difficult. In fact, among the countries adopting the single-regulator model, only few have been able to design a single supervisory framework to harmonise regulations and supervisory approaches across the entire financial system.[135] The UK is one of these few,[136] but in doing so, has benefitted not only from its concentrated financial system and rich supervisory experience, but also from the long tradition of self-regulation, thanks to which there were comparatively fewer existing legislations and thus a lower difficulty/cost of integration. By contrast, the mere consolidation of agencies in China would already mean a tremendous cost of reform, given the magnitude of the three Commissions together with their provincial and local

Protection and Markets Authority, an idea similar to the so-called Twin Peaks approach adopted by Australia. Viewed together with the fact that the FSA was set up in 1997 when the Labour Party had just won the election, and the argument that the switch at that time to a single regulator was a policy decision made in response to political pressures unconnected to the evolving nature of financial markets (see, for example, Alistair Alcock, 'A Regulatory Monster', *Journal of Business Law* (1998) p. 371, at pp. 372-375), this reform decision reminds us of the extent to which (the establishment and abolishment of) the FSA has been used as a weapon against political rivals.

[135] See Martínez and Rose, *supra* n. 5, at p. 31.

[136] The value of establishing a legal framework specifically designed to support the effectiveness of the single regulator model was recognised in the UK. The 'easy' option of simply piecing together the existing sectorally-based legal regimes and vesting all of those existing powers in the FSA was ruled out in favour of the much more ambitious approach of providing a fully integrated common legal framework. Thus, the FSMA gives the FSA broad powers to regulate across the financial sector, and the FSA exercises those powers in accordance with uniform objectives, approaches and rules, based on the same 'rulebook'. See Eilis Ferran, 'Do Financial Supermarkets Need Super Regulators: The United Kingdom's Experience in Adopting the Single Financial Regulator Model', 28 *Brooklyn Journal of International Law* (2003) p. 257, at pp. 292-93.

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affiliates. As to the unification of rules, this seems almost a mission impossible in the foreseeable future considering the status quo of the financial legal system in China.

Finally, the independence of regulation is somewhat staggering in China given the short history of the current system, the high percentage of state-owned enterprises in the financial sector and the complex relationship between regulatory agencies and financial institutions. Against this backdrop, an integrated, single-regulator system is arguably more prone to government intervention and agency capture than a multiple-regulator system. Besides, at this point in time, China is an emerging plus transitional economy and the Chinese financial market poses too many unique and difficult regulatory problems. Perhaps it would be too risky to entrust all this to the centralised judgment of a single agency. In contrast, a check and balance between different regulatory agencies under a multiple-regulator structure is more likely to facilitate safe and sound decisions and lower the risk of regulatory error.

6.5 Lessons from the global financial crisis

6.5.1 *Major anti-crisis measures taken by the EU and US*

The impact of the world's worst financial crisis since the Great Depression is widespread and far-reaching and has resulted in multifaceted legislative and regulatory reactions in the EU and US.

The reaction at the EU level includes, without limitation, the creation of the European System of Financial Supervisors and the European Systemic Risk Board,[137]

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[137] Recognising the limited role that national supervisors can play with respect to mega-financial conglomerates operating across the border, and the insufficiencies of the mere coordination and information-exchange mechanism among national authorities as mandated by the Supplementary Supervision Directive and other relevant directives, the European Commission proposed, in February 2009, to create a European System of Financial Supervisors comprising three European Supervisory Authorities, for banking, securities and insurance firms respectively, and to set up a European Systemic Risk Board (ESRB). In September 2010, the European Parliament approved the proposal, authorising the establishment of the European Banking Authority (based in London), the European Securities and Market Authority (based in Paris) and the European Insurance and Occupational Pensions Authority (based in Frankfurt), as well as the ESRB (also based in Frankfurt) to be chaired by the President of the European Central Bank. The pan-EU supervisory authorities, scheduled to begin work at the start of 2011, will have the power to mediate between national supervisors and to impose their decisions directly on financial firms if any national supervisor fails to implement their recommendations. See the European Parliament legislative resolution of 22 September 2010 on the Proposal for a Directive of the European Parliament and of the Council amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority (COM(2009) 0576 – C7-0251/2009 – 2009/0161(COD)), Strasbourg, 22 September 2010.

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a proposed new directive on the supplementary supervision of financial conglomerates,[138] proposed early crisis intervention measures as well as regulation on derivatives and hedge and private equity funds,[139] and public consultation on amendments to the Capital Requirements Directive which would address liquidity standards, the leverage ratio, counterparty credit risk and systemically important financial institutions.[140] One lesson Europe has learned from the crisis, in particular from the collapse of several high-profile banks and its chaotic consequences for Member States, is that no entity should be 'too big to fail'. The overriding objective will thus be to ensure that banks can fail without jeopardising wider financial stability. This means banks can be resolved in ways that minimise the risks of contagion and ensure continuity of essential financial services, including continuous access for bank account holders to their accounts. A credible alternative should be provided to the expensive bank bail-outs seen in the last couple of years. To this end, the European Commission proposes to build on existing supervisory colleges (groups of national supervisors) to set up resolution colleges (where supervisors and national authorities in charge of resolution would meet), for the purposes of crisis preparation and management. It also proposes that the new European Supervisory Authorities and in particular the European Banking Authority should have coordination and support roles in crisis situations, without impinging on the fiscal responsibilities of Member States.[141]

The United States, in passing the Dodd-Frank Wall Street Reform and Consumer Protection Act (herein 'Dodd-Frank Act' or 'Act'),[142] launched the most comprehensive reform of its financial system since the New Deal. The two pillars of the Act are

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[138] The focus and primary aim of the proposed directive, which is to replace the Supplementary Supervision Directive of 2002, is to ensure appropriate supplementary supervision, i.e., to fill the unintended gaps that have developed in supplementary supervision due to definitions in the sectoral directives, namely the Banking Directive 2006/48/EC and the insurance directives. Major changes include, without limitation, the introduction of the concept of 'mixed financial holding company', the inclusion, under all circumstances, of asset management companies in the scope of supplementary supervision, differentiated treatment of small groups and large, complex groups in applying the threshold test, and amendment of the definition of relevant competent authority and supervisory coordination. See Proposal for a Directive of the European Parliament and of the Council amending Directives 98/78/EC, 2002/87/EC and 2006/48/EC as regards the supplementary supervision of financial entities in a financial conglomerate, Brussels, 16 August 2010 (COM(2010) 433 final).

[139] European Commission Press Release, 'Commission Sets Out Its Plans for a New EU Framework for Crisis Management in the Financial Sector', Brussels, 20 October 2010 (IP/10/1353).

[140] European Commission Press Release, 'Financial Crisis Response: Commission Asks Stakeholders for Views on Further Possible Changes to Capital Requirements Directive', Brussels, 26 February 2010 (IP/10/197).

[141] European Commission Press Release, *supra* n. 139.

[142] Dodd-Frank Wall Street Reform and Consumer Protection Act, Washington, 29 June 2010 (H.R. 4173).

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the supervision of systemic risks and the protection of financial consumers. Similar to what is being considered by the European Commission, the Act seeks to end the 'too big to fail' curse by authorising the Federal Deposit Insurance Corporation to liquidate those collapsed mega-financial conglomerates, or 'covered financial companies' (i.e., financial institutions determined by the Secretary of the Treasury to have systemic significance) under the so-called 'orderly liquidation authority'.[143] Preventatively, the Dodd-Frank Act expands the supervisory power of the Federal Reserve, subjecting all systemically important banking and non-banking financial institutions to its prudential supervision.[144] In addition, the Act establishes the Financial Stability Oversight Council (FSOC) consisting of the heads of the federal financial supervisory authorities and some non-voting members, and grants it broad authority to identify risks to financial stability, promote market discipline and respond to emerging threats to the stability of the financial system.[145] As to the consumer protection aspect, the Dodd-Frank Act establishes, within the Federal Reserve System, an independent bureau, i.e., the Bureau of Consumer Financial Protection, to regulate the offering and provision of consumer financial products or services under the federal consumer financial laws.[146] The Act also provides for enhanced regulation on financial derivatives, hedge funds and private equity funds.[147]

6.5.2 *Policy implications for China*

To be sure, things are quite different in China than in the EU or US. Thanks to its underdeveloped financial market and somewhat isolated capital market, China has largely escaped the impact of the global financial crisis, albeit unintentionally. In a sense, Chinese financial conglomerates are simply too rudimentary to share many of the 'grown-up pains' suffered by their EU and US counterparts. For example, the Basel III Accord reached by the Basel Committee in September and endorsed by the G20 leaders in November this year, by requiring that banks raise their tier 1 capital ratio to 6% (from 4% in Basel II) and the core tier 1 capital ratio to 4.5% (from 2% in Basel II) by 1 January 2015, and hold a capital conservation buffer of 2.5% by 1 January 2019, puts great pressure on EU and US financial conglomerates with banking activities. The new Accord, however, is of limited concern to China. The capital adequacy ratios of Chinese banks, especially of the SOCBs, are much higher than the international average level. To specify, all of the five biggest SOCBs have a capital adequacy ratio above 11% and a core capital adequacy ratio above 9%,

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143 Dodd-Frank Act, Title II.

144 More specifically, the Federal Reserve is authorised to supervise non-bank financial companies determined by the Financial Stability Oversight Council as posing a threat to the financial stability of the United States. See the Dodd-Frank Act, Sec. 113.

145 Ibid., Sec. 111.

146 Ibid., Sec. 1011.

147 Ibid., Titles IV and VII.

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largely due to the limited availability of debt capital in an underdeveloped capital market.[148]

Nevertheless, the crisis and anti-crisis measures taken so far are not without relevance to China. Afflicted by the failure of such financial giants as Lehman Brothers and Fortis Bank, both the EU and US attach great importance to the systemic significance of such large, complex financial conglomerates, or so-called 'systemically important financial institutions' (SIFIs), and are proposing special regulatory rules such as higher capital adequacy ratios, limitation on leverage, and liquidity and risk management requirements. The newly established Financial Stability Board has also made specific recommendations for reducing the moral hazard posed by SIFIs.[149] Arguably, many of the financial conglomerates in China, especially those formed around the SOCBs and large insurance companies, qualify as SIFIs and warrant special supervisory attention.[150] Actually, China has moved in this direction: since 2009, the Banking Commission has raised the capital adequacy ratio of large commercial banks to 11.5%, higher than what is required for medium and small banks (10%).

Another remarkable aspect of the anti-crisis measures is the rediscovery and reinforcement of the role of central banks in financial supervision. The new European Systemic Risk Board (ESRB) is to be chaired by the President of the European Central Bank; the Federal Reserve is authorised by the Dodd-Frank Act to supervise non-bank financial institutions with systemic significance; and with the abolishment of the FSA and the establishment of the Prudential Regulation Authority under the Bank of England, the UK is returning to its tradition where the central bank plays a dominant role in financial supervision. This trend coincides with the author's argument above that the People's Bank should have a more visible and meaningful presence in the supervisory structure concerning financial conglomerates.[151]

Finally, single regulation has not been accepted as a cure to the regulatory chaos resulting from the crisis. Neither the European System of Financial Supervisors nor the Dodd Frank Act seeks to set up a single regulator for the whole financial

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148 For a more detailed argument to this effect, see Zhang Wei, 'Basai'er Xingui Dui Zhongguo Yingxiang Buda' [Report: The New Basel Accord Does not Affect China Much], 20 September 2010, available at: <http://news.xinhuanet.com/fortune/2010-09/20/c_12588284.htm>, last visited on 3 December 2010.

149 Financial Stability Board, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines*, 20 October 2010.

150 Specific criteria for or a list of Chinese SIFIs, however, are yet to be issued. According to the Banking Commission, the identification approach and regulatory framework for domestic SIFIs are still under research. See Liu Shiping and Su Xueyan, 'Yinjianghui: Guonei Xitongxing Zhongyao Yinhang Biaozhun Ji Mingdan Shangwei Mingque' [Report: Banking Commission Said the Criteria for and List of Domestic SIFIs Are Yet to Be Specified], *Xinhua News*, 26 November 2010, available at: <http://news.xinhuanet.com/fortune/2010-11/26/c_12820926.htm>, last visited on 3 December 2010.

151 See sections 6.2 and 6.3 above.

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industry. Instead, emphasis is placed on more substantial and effective cooperation between sectoral supervisors and the identification of systemic risks, as exemplified by the establishment of the ESRB and FSOC. This also coincides with the author's argument above that what is needed now in China is not a hasty integration of financial regulators, but rather the establishment and operation of an official regulatory cooperation and coordination mechanism led by the People's Bank, with the necessary 'teeth' such as a dispute resolution mechanism.[152]

7. Conclusion

The recent development of financial conglomerates in China has strongly challenged the existing regulatory regime and has urgently called for regulatory coordination. What is needed, however, is a dispassionate analysis of the real problems in practice and their solution, rather than a hasty transplant of any 'advanced' or 'superior' model. It should always be borne in mind that the establishment of any regulatory coordination mechanism, just like the choice of any regulatory model, is subject to the peculiarities of a country, i.e., to its political, economic and historical conditions as well as the conditions of its financial market and regulatory resources. In this sense, each country has its own unique reasons for choosing or not choosing something.

In China, so soon after the separated regulation system was established and as the resulting costs and benefits are far from being sufficiently calculated, the first priority should be to maintain the continuity and stability of the system. It seems to the author that by sanctioning the principle of functional regulation and establishing a coordination mechanism led by the People's Bank, China should be able to resolve most of the problems existing in practice without a revolutionary change to its regulatory structure. The author also believes that this should be the basic orientation of the country's financial regulatory reform both at present and in the foreseeable future.

[152] See section 6.2.3 above.

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