The Unbearable Heaviness of Banking Regulation in China

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- State ownership and banking
    - Will China face a crisis like Greece?

- During China’s first three decades of reform, private sector development occurred in parallel with prioritization of state-owned enterprises in strategic industries, and growth surged. This pattern of state capitalism rested on an unarticulated bifurcated financing arrangement whereby the formal banking system primarily served public enterprises, while private businesses relied primarily on informal finance. However, China’s response to global financial crisis disrupted the preceding equilibrium of financial dualism under state capitalism. Unprecedented expansion of bank lending after 2008 created opportunities for a host of state economic actors—including SOEs, state banks, and local governments—to expand their participation in off-balance sheet activities.

- Kellee S. Tsai , *The Political Economy of State Capitalism and Shadow Banking in China* (May 2015)

- (i) the concentration of large state-owned banks which serve the financial needs of the major state-owned enterprises but offer limited credit to small businesses, to peasants or to the agricultural sector;

- (ii) the rampant shadow banking activities and accompanying risks; and

- (iii) the weak corporate governance of banks.

Background

- Separating Commercial Banks from the Central Bank
    - In 1978, the central government separated the fiscal and banking functions through splitting the People's Bank of China (PBoC) from the Ministry of Finance. PBoC was a unified monobank in which the central bank served as the monetary authority, a commercial bank, and a fiscal agent of the central government. (The privately owned banks were not permitted.)
    - In 1984, the central government decided to create State-owned commercial banks to carry out commercial lending and to specify the role of PBoC as that of a modern central bank.

- Soft budget constraint (János Kornai)

Limited Liability

- (1) legislation (i. e. , the General Principles of Civil Law of 1986 ("1986 GPCL”)
- (2) judicial interpretations issued by the Supreme People’s Court; and
- (3) publicly released judicial opinions.

- The liability rule changes: initially the investors were protected by limited liability (1986); Then the rule changed to unlimited liability (1987); Afterwards, it came back to limited liability (1990); Finally the courts seemed to reach a balance by setting up the three-step test (1994).

- 1). General Principles of Civil Law of 1986

- Limited liability had been attached to the concept of legal person when the General Principles of Civil Law were passed. A legislative report by the Secretary General of the People's Congress showed that one of the intentions of the legal person article of GPCL was to guarantee that the government not liable for public enterprises, namely State Owned Enterprises (hereinafter SOEs) and Collectively Owned Enterprises (hereinafter COEs). Accordingly, SOEs and COEs should assume their obligations only with their own assets without referring to the government (their investor).

- (2) The First 1987 Judicial Interpretation
- Statutes in China need to be applied by the court. So the opinion of the People's Supreme Court of China (hereinafter SPC) is very important to understand statute. For the issue limited liability, the SPC confirmed it through a judicial interpretation in 1987. When the lower court inquired on whether the court should hold the investors of some rural enterprises liable, SPC replied that the legal personality test should be used in deciding the liability. More specifically, the court instructed that limited liability should apply provided that the enterprise is a legal person, hence confirmed limited liability.

- (3) The Second1987 Judicial Interpretation

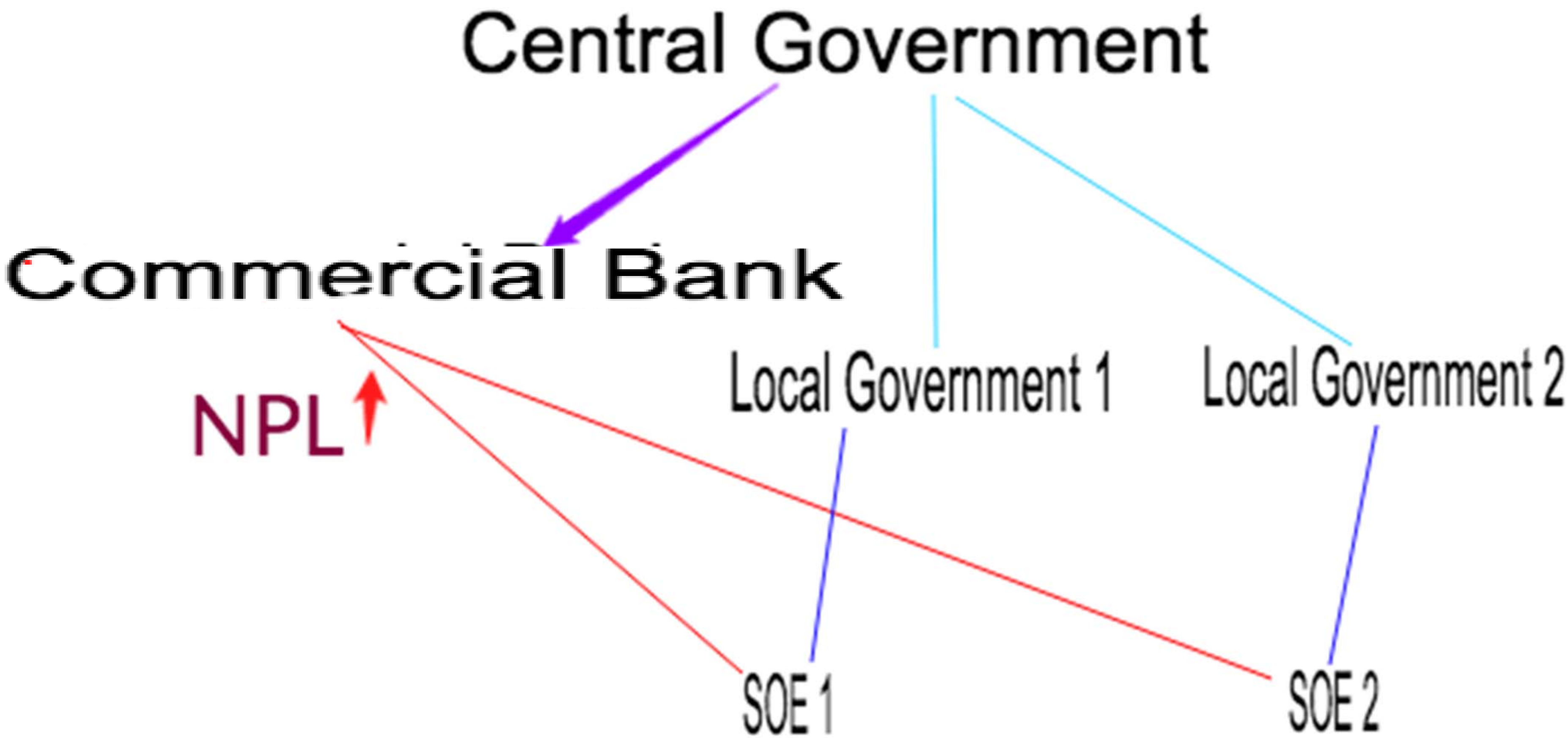
- Only a month after the confirmation SPC reversed the legal person test in a new judicial interpretation. SPC ruled that investors of the “company” must be liable for its debts. This interpretation was in contradiction with the previous one. Companies were usually registered as legal persons. According to the former judicial interpretation, investors of a company should not be liable for debts. But the present judicial interpretation stipulated that investors of companies should be liable for the debts. With this exception SPC actually reversed limited liability.

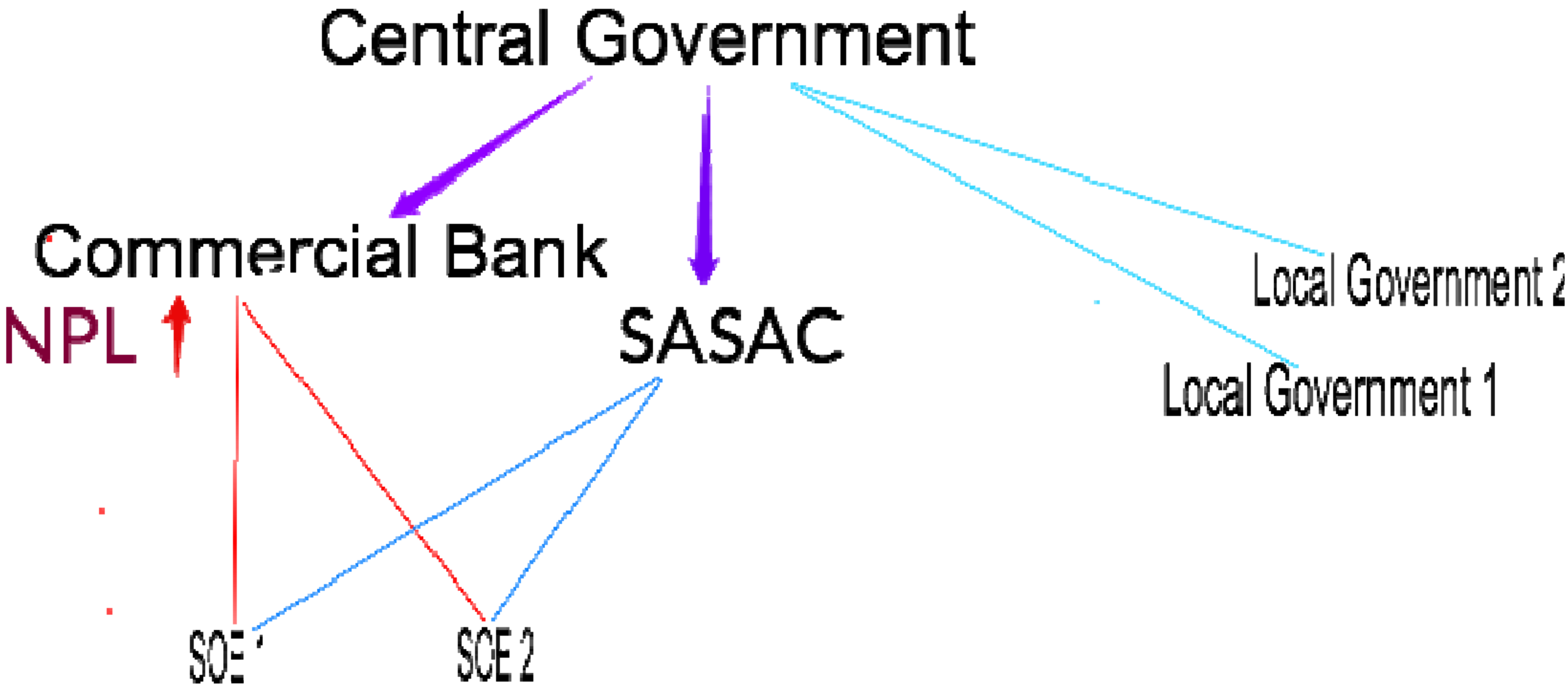
- (4) 1990 State Council Rule
- The State council promulgated a rule in 1990 that led to a drastic change again. Its provisions limited the investors' liability to the registered capital: for those companies which had been doing business independently, investors should not be liable at all; for those companies had been doing business with their investors, liability was limited to the registered capital that investors should put in the companies. By this rule limited liability was reestablished as the default rule. It greatly reduced the obligations of investors. Compared to the former rule, investors did not need to worry the unlimited liability from their firm's debts. Liability then became both predictable and controllable.

- 5). The 1994 Judicial Interpretation
- PC ruled that investors should be held liable for all the enterprise’s debts if capitalization under the minimum capital is found. Hence SPC adopted the three-step test.

- What is behind the evolution of Limited Liability?

- Limited liability and Non-Performing Loans


Central Government
Commercial Bank
NPL
Local Government 1
Local Government 2
SOE 1
SOE 2



Central Government
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- Conclusion