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2.1 Domestic Commercial Banks

2.1.1 Four State-owned Commercial Banks (the Big Four)

China's largest four State-owned commercial banks, ie the Bank of China, China Construction Bank, Agricultural Bank of China and Industrial and Commercial Bank of China, are major market players in China's banking sector and dominate commercial banking business. The Postal Savings Bank of China was set up in December 2006 and started its operations in March 2007. It is the fifth state-run commercial bank in China.

The Big Four are dominant in the financial market in China. As early as 1999, the Big Four had total assets of RMB8.854 trillion, which is nearly eight times the total of other commercial banks.[1] However, the Big Four performed very poorly: their average profit-to-capital ratio was 3.2%, which was significantly lower than the 11.9% of some other commercial banks. The Big Four also had a lower capital adequacy ratio of 9 to 10%, compared with roughly 20% for other commercial banks.[2] The Big Four were technically insolvent before their IPOs, crippled by bad loans built up over many years. The PRC Government has made considerable efforts to upgrade the Big Four's operations, with the aim of improving their capital adequacy ratios and corporate governance. After a series of bail-outs and bad loan carve-outs starting in the late 1990s, the Chinese Government succeeded in reviving most of the country's largest lenders before carrying out a major capital injection from its foreign reserve in preparation for the Big Four's initial public offerings (IPOs). Up to 2010, the Big Four had completed their dual listings in Hong Kong and Mainland China. In the process of corporatising the Big Four, economic performance and operational efficiency of commercial banks have been enhanced. The capital adequacy ratios of the Big Four increased from 2.11% to 12.58% between 2003 and 2008.[3] The non-performing loan ratio of the Big Four in the same period decreased from 16.84% to 2.55%.[4] The average return on assets of the banks

1 Annual Report of the People's Bank of China, 1999.
2 Wai Chung Lo, "A Retrospect on China's Banking Reform", in Hung-Gay Fung and Kevin H. Zhang (eds), "Financial Markets and Foreign Direct Investment in Greater China", Armonk, New York and London, England: M.E. Sharpe (2002), p46.
3 Jia Cai Yang, "Reforming Big Banks: Moving Forward from a New Starting Point", (http://news.stockstar.com/Info/Darticle.aspx?id= JL,20081118,00000281&columnid=1823), p1.
4 Ibid.

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exceeded 0.7%, close to the 1% ROA performance of the top 100 banks in the world.[5] While Western banks have been plagued by the financial crisis in 2008, Chinese banks having been performing well with a 30.6% increase of net profits in 2008.[6]

The Big Four now concentrate on lending in China's main cities for major projects on a commercial risk basis. The commercialisation of the Big Four is to prevent them from lending money to chronically loss-making State-owned enterprises. Nevertheless, the reality is that the Big Four have never really been entirely freed from policy-loan responsibilities. Although the Big Four have all been listed, they are largely owned and controlled by the Chinese Government. The Government policy steers their commercial activities. One indication is that the senior executives of the Big Four are all appointed by the Government and they tend to bear more of the political responsibilities while mid-level managers are more performance-driven.

2.1.1.1 Industrial and Commercial Bank of China

Founded in 1984, the Industrial and Commercial Bank of China (ICBC) is China's and the world's largest commercial bank, as measured by assets, with a market capitalisation of nearly $300 billion.[7] ICBC's US$240 billion market value is of the combined worth of JP Morgan Chase and Barclays.[8] The ICBC mainly focuses on local currency lending and deposit-taking for Chinese commercial and industrial enterprises. Like the other members of the Big Four, it has an extensive network of branches in China and possesses the largest customer base in China, about 100 million individual customers and 8.1 million corporate customers. The bank has an extensive network of over 22,000 branch offices across China and its staff exceeds 400,000.[9] The

5 Mingkang Liu, "China's Banking Reforms: the Development and Historical Changes", Qiu Shi (2007), No.20, pp25-28.

6 CBRC, "The Report on Opening Up China's Banking Sector", CBRC (2007) (http://www.china.com.cn/policy/txt/2007-03/22/content_9252691.htm), p5.

7 By the end of 2002, the total assets had approximately been RMB4.8 trillion. In 2009, ICBC's market capitalisation was US$259.7 billion. See Patrick Jenkins, "China Lenders Eclipse US Rivals", Financial Times (1 November 2010), p15. Given its fast growth of profit at the annual rate of 15% in 2009 (US$18.7 billion or so), ICBC is on an impressive performance track and its market value grows fast as well. Jamil Anderlini, "ICBC to Curb Some Areas of Lending", Financial Times (28 January 2010), p14.

8 Jane Cai and Ray Chan, "Goldman Sachs Sells Last ICBC Stake, Reaps Billions", South China Morning Post (21 May 2013) (online).

9 See ICBC website: http://www.icbc.com.cn/e_about/index.jsp?column=About+Us%3Ebrief+Introduction.

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bank has branches in Hong Kong, New York, London, Luxembourg, Frankfurt, Abu Dhabi and many other international locations.

ICBC has joined the league table of the world's top credit card issuers and occupied the highest ranking of the five fast-growing banks, with 54 million credit cards in issue. Apparently, ICBC is catching up fast with the world's number one, JPMorgan, and issued 96 million cards.[10]

ICBC was corporatised by promotion of a new company limited by shares in October 2005. Huijin and the Ministry of Finance were two major promoters.

Prior to ICBC's dual listing in Hong Kong and Shanghai in 2006, Goldman Sachs Group Inc., Allianz Group and American Express Company invested US$3.78 billion in ICBC in exchange for 10% of ICBC's equity, which was announced on 27 January 2006.[11] Allianz Group and American Express Company took 2.01% and 0.4% of ICBC's equity. Goldman alone bought a 4.9% stake in ICBC for US$2.58 billion.[12] ICBC went public in Hong Kong and Shanghai on 27 October 2006, raising US$22 billion in total.[13] As none of these three strategic foreign investors was in the commercial banking industry, each then can be seen as a foreign "financial" investor, which can bring other business lines to ICBC. For instance, Goldman brought underwriting, Allianz insurance, and American Express credit cards into ICBC, which did not have these strong lines in its conventional business operations.

At its IPO, ICBC boasted 18,038 "domestic branches, outlets, and other establishments" in June 2006, and 98 "overseas branches, subsidiaries, representative offices, and outlets".[14]

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10 Patrick Jenkins, "Brazil and China Banks Join List of World's Top Credit Card Issuers", Financial Times (4 October 2010), p1.

11 Industrial and Commercial Bank of China, "ICBC Announces Strategic Investment and Partnership Agreement", Industrial and Commerical Bank of China (27 January 2006) (http://www.icbcltd.com/jsp/en/template/infoContentTemp.jsp?path=ROOT?3EAbout+Us%3Enews&id=1138348278100&type=CMS.STD).

12 Nisha Gepalan and Peter Stein, "Goldman to Cut Stake in ICBC Again", The Wall Street Journal (30 September 2010), p19.

13 Dow Jones Newswires, "AgBank Near IPO Launch", The Wall Street Journal (7 June 2010), p22.

14 ICBC, "ICBC Hong Kong Offering Prospectus", ICBC (October 2006), p102.

wholly owned unit, the bank again will need to undergo a time-consuming process involving the banking regulator and other competent Government bodies such as the tax authority and company registry. HSBC and Citigroup have done so to obtain their licenses for wholly owned units in China. The shortcut route to set up units in a free-trade zone in Shanghai is for sure to attract more international banks to secure a foothold in China.

This is the key element in the milestone plan, a new policy initiative to turn Shanghai to be a global business hub and international financial centre. Other elements in this milestone plan is to encourage domestic private firms and foreign enterprises to set up financial services companies, such as accounting and rating agencies, in the free-trade zone. These initiatives capture the key disadvantage Shanghai has right now, the weakness in capital flow and commodity exchange. Allowing foreign banks to provide clearing services to financial transactions will further boost the international use of renminbi.

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Chapter Six: DEBT FINANCING

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The legal rules governing the financing of companies are the primary focus of this chapter. The purpose of this chapter is to outline the basic components of the capital structure of a company. This chapter considers some factors which may be taken into account by the management of a company when making financing choices.

By way of background, there are generally three ways for a company to finance its operations: equity financing; debt financing; and retained profits. Together, these constitute the concept of "corporate finance". The focus of this chapter is debt financing, whereby a company raises funding through borrowing, either from a lender or a shareholder. Borrowing capital from a lender is a typical way of debt financing whereas borrowing capital from a shareholder is often termed as a "shareholder loan". In addition, corporate bonds and initial public offerings are also discussed in the context of corporate finance. In the Chinese context, given the dominance of Chinese banks in the market, bank financing is the major form of corporate borrowing. Technically, there is no big difference between a bank loan and a shareholder loan.

The starting point of understanding debt financing in the context of Chinese law is to distinguish domestic companies and foreign-invested enterprises, which are subject to two parallel and autonomous company law regimes.

6.1 Two Sets of Company Law in China

The People's Republic of China (the PRC or China)[1] did not have its own company law until 29 December 1993 when the Standing Committee of the National People's Congress (the NPC) promulgated the Company Law. The Company Law was further amended on 27 October 2005. The amended Company Law came into force on 1 January 2006. In the intervening period, the PRC economy became increasingly open and market-oriented, and needed a further reshuffle of China's corporate law so as to boost the operational efficiency and productivity of Chinese companies and serve the structural needs of China's capital market. Although the time was ripe for an overhaul, the Chinese Government did not undertake a wholesale reform

1 For the purpose of this chapter, the PRC or China does not include the Hong Kong Special Administrative Region, the Macao Special Administrative Region and the Territory of Taiwan.

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of the existing Company law. Rather, in recognition of the need for a more business-friendly corporate law, China has adopted a piecemeal or step-by-step approach by, among others, easing certain restrictions on capital rules, enhancing existing corporate governance, and introducing more shareholder protection provisions. The amended Company Law, therefore, represents a stepping stone in its quest for what is thought to be an eventual consolidation of a corporate regime, applicable to domestic entities, as well as foreign-invested enterprises (FIEs).

Before the Company Law of the PRC came into force in 1994, companies in China were largely regulated by State-owned enterprise regulations and FIE laws. Of all the legal institutions that were rebuilt or created in the past three decades, those related to foreign direct investment (FDI) have developed the fastest. The urgency of attracting FDI and satisfying foreign investors' needs to have their investments well protected triggered the tremendous effort to create and grow an FDI regime. As such, it is not surprising to see the first piece of legislation enacted right after the adoption of the "opening door" policy – the PRC Sino-Foreign Equity Joint Venture Law (the EJV Law)[2]– which was intended to encourage foreign participation in China's modernisation program. Other primary legislation and secondary implementing regulations in subsequent years allowed foreign companies to set up representative offices,[3] wholly foreign owned enterprises (WFOEs),[4] and contractual joint ventures (CJVs)[5] in China. The fourth Constitution, revised in 1982, contains a critical provision promising to protect "the lawful rights and interests of foreign investors".[6] These laws hit a roadblock on the ideology underpinning China's first thirty years of practice when China often condemned foreign investment as an expropriation of developing countries. A large body of laws centering on the encouragement and protection of FDI were promulgated later on. Tax rules, foreign exchange controls, customs regulations, and intellectual property laws were drafted and promulgated. Nonetheless, the foreign investment policy at the early stage was primitive and inconsistent, moving between

2 Promulgated by the NPC and effective as of 1 July 1979, amended on 4 April 1990 and 15 March 2001.

3 Interim Regulations concerning the Control of Resident Offices of Foreign Enterprises (promulgated on 30 October 1980).

4 The Law on Enterprises with Sole Foreign Investment (adopted on 11 April 1986).

5 The Law on Sino-Foreign Co-operative Enterprises (adopted on 13 April 1988).

6 PRC Constitution 1982, Art 18 (adopted on 4 December 1982).

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two extremes of openness and restriction. A widespread lack of uniformity, inconsistency, and self-contradiction occasionally endangered the foreign investment community's confidence in China. No denial can be made of the economic and societal contribution, and the legal institutions and infrastructure hastily rebuilt in the wake of the Cultural Revolution, although they were proved to be far less than anticipated.

6.2 Several Types of Companies

6.2.1 Limited Liability Company (LLC)

An LLC is defined by the Company Law as "an enterprise legal person which has independent legal person property and enjoys legal person property rights".[7] Further, the Company Law clarifies that "a company shall be liable for its debts to the extent of all its property", and "a shareholder of a limited liability company (as well as a company limited by shares) shall be liable to the company to the extent of the capital contribution it subscribes".[8] As such, the Company Law codifies two modern corporate law principles: the doctrines of separate legal personality and limited liability. An LLC is analogous to private companies in some common law jurisdictions.

As FIEs in China are mostly not governed by the Company Law of the PRC, they are often regarded as a separate category of companies from pure domestic companies which are only invested by Chinese individuals or companies. Pure domestic companies are subject to the Company Law. Subsidiaries of FIEs are also regarded as Chinese domestic companies and thus governed by the Company Law, except for some subsidiaries in some restricted categories of the Foreign Investment Industrial Guidance Catalogue (the "Catalogue")[9] such as the telecoms sector which are more often treated as FIEs subject to various foreign investment restrictions. Although companies incorporated under the Company Law are further categorised into LLCs, companies limited by shares, and single shareholder companies, they are in essence limited liability companies.

In principle, an LLC under the Companies Law shall be incorporated by less than 50 members with joint capital contribution.[10] The Company Law

7 Company Law, Art 3.

8 Ibid.

9 The latest Catalogue was issued by the National Development and Reform Commission and the Ministry of Commerce on 24 December 2011.

10 Company Law, Art 24.

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The major weakness in this creation system is the lack of certainty of Chinese security devices for securing future advances. The operation of floating charges is still unclear given the short history of its existence in China.

The rules governing the perfection of securities over tangible personal property in China are also, generally, simple and comprehensive. The registration process in China can be expeditious and costs are minimal. Yet, its weakness is obvious: too many authorities can be involved due to the nature of a mortgaged property, which can give rise to complications. This high level of complexity may create additional transaction costs in commercial transactions.

In terms of publicity, Chinese rules have some strengths. First, the cost of publicity is minimal and any relevant third party may easily gain access to necessary information. Second, the rule that a registration date determines the ranking of priority encourages parties to race to the registration authority and pushes for diligence of creditors in registering and protecting their own rights. Still, uncertainty lies in the fact that Government authorities may not register information correctly especially where there is not a well-organised database, and the authorities may be slow to process and respond to enquiries.

Although no period is fixed in either the Property Rights Law or the Security Interest Law for registration of a charge in Mainland China, this would not create confusion or difficulty among creditors. A prudent secured creditor will register a charge as soon as possible since the Property Rights Law and the Security Interest Law provide that priority between competing claims is determined by the date of registration. This rule suggests that the Chinese filing system encourages diligence on the part of creditors. This can help increase efficiency as public investors can benefit from more timely information as to the financial status of a company.

The filing system in China is also based on the nature of assets encumbered. For instance, the Security Interest Law does not mention the nature of ownership.[224] Instead, it mandates registration according to the nature of assets. In other words, creditors need to register a particular mortgage with a competent authority that administers the type of assets concerned.

224 Secured Interest Law, Art 42(3).

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Chapter Eight: SHADOW BANKING SYSTEM IN CHINA

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While the banking sectors in Western countries have been heavily hit by the most recent financial crisis, the banking sector in China seems to have been performing well. Nevertheless, the existence of a shadow banking system in China, which is said to be one of the causes the current financial crisis, has recently made the situation take a turn for the worse. This chapter attempts to look into "shadow banking system" in the Chinese context and "rationalise" Governmental responses to the shadow banking regime.

8.1 Shadow Banking: A Brief Overview

There are two schools of thought explaining the causes of the latest financial crisis. According to the global savings glut theory, it was high-savings that fuelled flows of money from emerging market economies and pushed long-term interest rates down to rock-bottom levels, leading to asset bubbles in the United States and other countries.[1] By contrast, the global credit glut theory diagnosed the problem in an opposite way – it was the scale of global shadow banking that caused the trouble.[2]

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The report released by the Financial Stability Board (FSB) in November 2011 defines "shadow banking" as "credit intermediation involving entities and activities outside the regular banking system".[3] Put differently but simply, shadow banking is the realm of lending that does not rely on deposit-taking banks using customer money to fund loans. The report indicates that, during the period from 2002 to 2007, the shadow banking system increased by US$33 trillion, more than doubling in asset size from US$27 trillion to US$67 trillion.[4] This is 8.5 times higher than the total US

1 Gary Gorton, "Slapped by the Invisible Hand: The Panic of 2007", Oxford University Press (2007); Jason Hsu and Max Moroz, "Shadow Banks and the Financial Crisis of 2007 and 2008" in Greg Gregoriou (ed), "The Banking Crisis Handbook", CRC Press (2010) (http://ssrn.com/abstract=1574970).

2 Financial crisis can be divided into three categories. The 2008 crisis came with the collapse of previously rock-solid institutions such as Lehman Brothers. The 1997 crisis was unfolded when global investors lost faith in countries and pulled their money out of Asian countries. The 2007's Northern Rock crisis in the UK was more about a public run on one or more financial institutions.

3 It is widely recognised that the concept of credit intermediation involves maturity, credit, and liquidity transformation which can significantly reduce the cost of credit relative to direct lending. For details, see Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, "Shadow Banking", FRB of New York Staff Report (2010) (http://ssrn.com/abstract=1645337), No.458.

4 This is almost equal to a quarter of total financial assets of the 20 countries and the Eurozone covered in the FSB survey, or 111% of these countries' economic output. "Shadow Banking – Under the Spotlight", Financial Times (19 November 2012) (online).

current account deficit of US$3.9 trillion during the same period. It is estimated that the shadow banking system is around 25 to 30% of the global financial system and 50% of total global banking assets.[5] The shadow banking sector has been booming since the onset of the global financial crisis in 2008 with a total amount of US$67 trillion worldwide in 2012.[6]

"Shadow banks" in the context of Western countries is quite different and refer to buy-out firms, hedge funds, venture funds, and ordinary corporations which use their investors' money and wholesale funding to hire disgruntled bank traders, engage in direct lending, and escape traditional banking regulation.[7] In this sense, the shadow banking sector may also cover insurers, private equity capitals, or pension funds, which may in some cases provide much-needed funds to the real economy. Shadow banking is likely to exist in the form of complex chains of deals starting from securities lending or repo transactions and ending up in other investments vulnerable to investors when underlying asset values fall sharply. The shadow banking sector therefore takes on some bank-like attributes such as using short-term assets to fund longer-term lending, which is known as "maturity transformation". In more advanced economies, shadow banking remains a key channel of credit intermediation that complements the formal banking system. The growth of shadow banking is due to the technical innovation and regulatory changes in the past several decades. For instance, traditional banks have been under pressure to exit the regulated sector and rely on money-market-funds, securitisation and repo for more profits.[8] Shadow banking is somehow mixed or connected with all sorts of new forms of money such as derivatives, off-balance sheet vehicles, securitisation and other debt instruments. The financial regulatory landscape in the past several years was to put priority over rebuilding bank capital and the fight to save the Euro. In terms of the size, market-based sources of credit such as corporate bond sales and direct lending by hedge funds are half the size of the

5 Andrew Sheng, "Left Unregulated, the Shadow Banking Sector is a Financial Disaster to Come", South China Morning Post (12 November 2011), A13.

6 Reuters, "Regulators Aim to Shine Light on Shadow Banking", South China Morning Post (28 January 2013) (online).

7 For details, see generally Steven L. Schwarcz, "Regulating Shadow Banking", 31 Boston University Review of Banking & Financial Law (2011-2012), pp619-42.

8 Gary Gorton and Andrew Metrick, "Regulating the Shadow Banking System" (2010) (http://ssrn.com/abstract=1676947).

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traditional banking sector.[9] Non-depository institutions such as private equity and hedge fund investors have been more heavily involved in some more "conventional" sectors such as the distressed shipping industry, ranging from buying ships to purchasing loans from banks that have previously financed the sector.[10]

The shadow banking system is complicated as it involves structured investment vehicles, money market funds and public financial institutions such as government-backed mortgage lender. In this sense, shadow banking is no longer the traditional loan-to-own space but is closer to loan-to-loan to fill up the gap created by the credit crunch. For example, a firm with a securities portfolio can build a shadow bank by lending it out for cash and then using the cash to make loans. Their combined credit creation and proprietary trading and hedging may account for much of the global liquidity flows. The cause of shadow banking's popularity is multi-fold. Investors are struggling to find places to use their money in a profitable manner. Regulatory pressure and costs may press investors to find a sensible way to get around legal or regulatory restrictions. Shadow banking facilities go for higher returns at the cost of introducing riskier financial instruments. Apart from its weaknesses and shortcoming, shadow banks also provide diversification for the financial system and resilience. From consumers' perspective, shadow banks offer more investment options and efficient pricing for consumers and businesses. In the Chinese context, the emergence of wealth management products and shadow banking facilities are shaking up a system that has relied on channelling funds to state entities.

9 Brooke Masters, "Call to Rein in 'Shadow Banking'", Financial Times (16 January 2012), p1.

10 Henny Sender, "Shadow Banks Tap into Distressed Shipping", Financial Times (1 January 2013) (online). There has been some increasing interest over the banking sector. Private equity firms are now more willing to expose themselves to the squeezed margins of the retail banking sector by betting that banks will be forced to shet assets at discounted prices in return for government bailouts or to meet more stringent regulatory capital requirements. Banking assets in Europe for example are now more appealing than elsewhere in the world partly because of their trading at low valuations and in part due to the fact that there have been no regulatory caps on private equity ownership of retail banks. Banking returns and market valuations, pinched by higher capital requirements and low interest rates, will ultimately recover. Jennifer Thompson, Anne-Sylvaine Chassany and Patrick Jenkins, "Private Equity Bets on Retail Banking", Financial Times (4 January 2013) (online).

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