

# **Establishing a Deposit Insurance System in China: A Long-Awaited Move Toward Deepening Financial Reform**

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## INTRODUCTION

The Deposit Insurance System (DIS) has long been considered a highly important financial safety net<sup>1</sup> to prevent bank runs<sup>2</sup> and to restore depositor confidence, which is why major economies in the world expanded their DIS coverage during the financial crisis of 2007-08. While most jurisdictions have set up DIS as an important financial infrastructure, China, the world's second largest economy, surprisingly did not adopt any explicit DIS until recently. After continuous debates for over two decades, the passage of the *Deposit Insurance Regulations* (the Regulations) by the State Council of China<sup>3</sup> in February 2015 was a long-awaited move toward better disciplining China's banking sector and enhancing financial stability.<sup>4</sup> The Regulations came into effect on May 1, 2015. An insurance promise for the protection of deposits can take place explicitly or implicitly. An explicit DIS clarifies the obligations of regulatory authorities to depositors, limits the scope for discretionary decisions, helps to contain the costs of failed bank resolution, and ultimately provides for a comparably transparent framework to deal with bank failures.<sup>5</sup> Before the announcement of the DIS,

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<sup>1</sup> There is no generally accepted definition of key elements of financial safety net. A narrow definition is limited to deposit insurance, lender of last resort function, and prudential regulatory and supervisory framework, while a more widely accepted one also includes failure resolution mechanisms for financial institutions. See FINANCIAL STABILITY FORUM, GUIDANCE FOR DEVELOPING EFFECTIVE DEPOSIT INSURANCE SYSTEMS, 7 (2001), [http://www.financialstabilityboard.org/wp-content/uploads/r\\_0109b.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_0109b.pdf). For a more detailed description, see also Sebastian Schich, *Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects*, Organization for Economic Cooperation and Development, Financial Market Trends, 2 (2008).

<sup>2</sup> A bank run is a situation that occurs when a large number of bank or other financial institution's customers withdraw their deposits simultaneously due to concerns about bank's solvency.

<sup>3</sup> The State Council is the chief administrative authority of the People's Republic of China. It is chaired by the Premier and includes the heads of each governmental department and agency. It directly oversees the various subordinate provincial governments and decides fundamental issues of the country.

<sup>4</sup> The Regulations are the official website of Legislative Affairs Office of the State Council, at [http://www.gov.cn/zhengce/content/2015-03/31/content\\_9562.htm](http://www.gov.cn/zhengce/content/2015-03/31/content_9562.htm) (last visited Aug. 13, 2015). The original Regulations are presented in Chinese and there is not a formal English version. Therefore, the understanding of the articles in the Regulations is based on the author's personal comprehension.

<sup>5</sup> For a comprehensive analysis of the comparisons between explicit DIS and implicit DIS, see Beat Bernet & Susanna Walter, *Design, Structure and Implementation of a Modern Deposit Insurance Scheme*, SUERF - The European Money and Finance Forum, at 19-20 (2009),

China had been using an implicit DIS as the main mechanism to deal with losses posed by failed depository institutions. Whenever a bank run occurred, China's central bank, the People's Bank of China (PBOC), would intervene and implement its "lender of last resort" mandate to pay out consumer funds and individual debts of distressed institutions. While this has been reasonably necessary to maintain financial stability and restore market confidence, the government bailouts have also subjected taxpayer funds to unacceptable risks and have increased moral hazard<sup>6</sup> in a very significant way. Furthermore, as a result of the "implicit" feature of the DIS, depositors could not anticipate whether, when, and how they would be reimbursed. When rumors concerning the failure of banks spread out, depositors would withdraw their savings within a very narrow timeframe, thereby accelerating the insolvency of relevant banks.

In the early 1990s, Chinese policymakers and regulatory agencies realized the defects of the implicit DIS and began moving their efforts towards establishing an explicit one. With ongoing research and continuous legislative attempts, the PBOC, in combination with the China Banking Regulatory Committee (CBRC)<sup>7</sup> and other regulatory bodies, designed a draft DIS in 2007. However, due to the outbreak of the global financial crisis, the legislative process was delayed. In the aftermath of the financial crisis, many jurisdictions recognized the insufficiencies of the existing DIS and reinforced its importance in maintaining financial stability. Reforms on DIS had been conducted by all major economies through various means, including expanding coverage limits, adjusting premium rates, and strengthening deposit insurers' mandates in failure resolution. China has drawn lessons from these reforms and revised the draft

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[http://www.suerf.org/docx/s\\_6547884cea64550284728eb26b0947ef\\_2437\\_suerf.pdf](http://www.suerf.org/docx/s_6547884cea64550284728eb26b0947ef_2437_suerf.pdf).

<sup>6</sup> Moral hazard is a situation in which one party gets involved in a risky event knowing that it is protected against the risks and the other party will incur the cost. In the context of a financial rescue, it is often referred to as financial institutions will engage in riskier activities knowing the government will bailout their losses and failures. For a comprehensive analysis of moral hazard, see RICHARD A. POSNER, *VALUES AND CONSEQUENCES: AN INTRODUCTION TO ECONOMIC ANALYSIS OF LAW* 121 (5<sup>th</sup> ed. 1998).

<sup>7</sup> The CBRC was established in 2003 when the PBOC transferred its banking regulation mandates into it. As authorized by the State Council, the CBRC is responsible for the regulation and supervision of depository institutions, while the Financial Stability Bureau of the PBOC still decides the liquidity support in the event of bank runs. See Country Report: China, Multi-Year Expert Meeting on Services, Development and Trade: The Regulatory and Institutional Dimension (Mar. 17-19, 2009), [http://unctad.org/sections/wcmu/docs/c1mem3p32\\_en.pdf](http://unctad.org/sections/wcmu/docs/c1mem3p32_en.pdf); see also Xiaoqing Fu & Shelagh Heffernan, *The Effects of Reform on China's Bank Structure and Performance*, J. BANK FINANCE (2008).

DIS.

In the wake of the Third Plenary Session of the 18<sup>th</sup> Central Committee of the Communist Party,<sup>8</sup> held in November 2013, China adopted a *Decision on Major Issues Concerning Comprehensively Deepening the Reform* (the Decision), which determined the direction of China's development for the following years under President Xi Jinping's administration.<sup>9</sup> The Decision sets the modernization of the financial market as an overarching goal of China's financial reform, and highlights that the creation of an explicit DIS is an urgent mission and a prerequisite for propelling future reforms. These future reforms include liberalizing interest rates and designing market exit mechanisms for financial institutions. After one year's preparatory work, the DIS was finally unveiled to the public, marking a fundamental turning point of China's financial industry. Nevertheless, questions and doubts have risen from the opening of this Pandora's box. It seems that China has just reached the starting point of an endless battle.

This essay explains the legislative process of the Chinese deposit insurance, describes its fundamentals and loopholes, and measures its implications on China's financial market. After the introduction, Part I will provide a brief overview of how China has been dealing with failures of depository institutions through the problematic implicit DIS. Part II highlights the need for an explicit DIS in China, which is made urgent by the agenda proposed to push forward future financial reforms. Part III furnishes the fundamentals of the Regulations and identifies some unresolved issues about which policymakers have remained silent despite their skepticism to the effective functioning of the new regime, drawing lessons from the United States, Europe, and Japan. Part IV further

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<sup>8</sup> Much as the Third Plenary Session of the Eleventh Central Committee of the Communist Party of China which was a pivotal meeting held in 1978 that marked the beginning of the "Reform and Opening-up" policy, this session held in November 2013 has viewed by many as another starting point for China's development. For more information about the session, see <http://english.cntv.cn/special/18thcpsession/homepage/index.shtml> (last visited Aug. 6, 2015).

<sup>9</sup> The Third Plenary Session came as China was facing major economic and social challenges. The Third Plenary Session and the Decision are together considered as a "turning point" that determines the direction of reform of the new leadership in China led by President Xi Jinping in the following years. For the contents of the Decision, see *Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform*, <http://lawprofessors.typepad.com/files/131112-third-plenum-decision---official-english-translation.pdf>.

provides an overview of the impacts that the DIS will pose on China's banking industry, banking regulatory structure, and depositors. A brief conclusion then follows.

## **I. IMPLICIT DEPOSIT INSURANCE: A HISTORY OF PROBLEMATIC BAILOUTS**

China's banking industry is burdened by governmental and political influences, often in ways that are not fully transparent or unambiguous. While it is perhaps idiosyncratic to analyze banking resolution in China through governmental and political lenses, it is also largely uncontested to date that the government's involvement in banking through ownership control, business decision-making interference, and all other forms of dictatorial interventions are likely responsible for wrongful bank operations and costly regulatory forbearance in the past decades.<sup>10</sup>

China has been operating an implicit DIS since the establishment of its contemporary financial system in 1979.<sup>11</sup> Unlike developed financial markets, China's financial industry was very immature at that time. Not only were there a very limited number of banks and other types of financial institutions, but also the services and functions of those institutions were quite simple. Banks were often government-backed and could not operate independently. The major breakthrough of China's banking industry took place in the mid-1980s with the commercialized functioning of the Big-Four banks (the Bank of China (BOC), Agricultural Bank of China (ABC), Industrial and Commercial Bank of China (ICBC), and China Construction Bank (CCB)), and with the establishment of a

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<sup>10</sup> Governmental intervention in the form of ownership and political control should have been responsible for heavy loan losses of Chinese banking industry during the planned economy period. See Patrick Honohan, *Protecting Depositors in China: Experience and Evolving Policy* in DEPOSIT INSURANCE AROUND THE WORLD: ISSUES OF DESIGN AND IMPLEMENTATION, 339-41 (The MIT Press 2008).

<sup>11</sup> From 1950s to the late 1970s, the PBOC served as not only the central bank but also the sole commercial bank in China. In 1979 after the "Reform and Opening-up" policy was proposed, the requirement of developing a competent banking system to satisfy the demand of the economic reforms was emphasized by Chinese central government and immediate steps were taken. The Agricultural Bank of China was re-established in February 1979; the Bank of China was separated from the PBOC and was directly accountable to the State Council (before this, the BOC was the International Department of the PBOC, handling foreign business in the name of itself); the Industrial and Commercial Bank of China was set up in 1984 to take over the commercial activities of the PBOC. See Yangxin Huang, *The Banking Market System*, in FINANCIAL REGULATION IN THE GREATER CHINA AREA: MAINLAND CHINA, TAIWAN AND HONG KONG, 27, (Kluwer Law International 2000).

large number of joint-stock commercial banks, city commercial banks, and urban and rural cooperatives. However, as the financial market became increasingly diversified and complicated, and as financial risks continued to accumulate, the insufficiency of regulators' capability to deal with bank failures became a conspicuous concern. Due to the regulatory inertia utilizing public injections to rescue banks, as well as the lack of regulatory techniques to prevent banks from losing their going-concern values, large-scale government bailouts were undertaken in the late-1980s. These problematic bailouts contributed to the increasing lack of market discipline.

#### **A. The Closure of Hainan Development Bank**

The Hainan Development Bank (HDB) closure case was the first bank closure case in China's financial history. As one of China's earliest regional commercial banks, HDB was established in 1995 by the government of Hainan Province to support the development of Hainan's special economic zone, under the basis of asset reorganization of five badly operated trust and investment companies.<sup>12</sup> The initial asset evaluation of HDB was simply based on the data of the balance sheets provided by the five companies without independent audit.<sup>13</sup> From the very beginning, HDB was built on a shaky foundation. The registered capital of HDB reached 1.67 billion RMB, but the actual raised capital was only 1.07 billion RMB.<sup>14</sup> To make matters worse, more than 50% of the initial capital went back to several founding shareholders in the form of loans. Eventually, HDB's total debts exceeded 5 billion RMB,<sup>15</sup> at a time when the market was devastated by the craze of overinvestment and the real estate bubble in Hainan was bursting.

At the end of 1997, Hainan's local government merged 28 troubled urban credit unions with HDB. These credit unions had similarly high levels of bad real estate debts, but even more toxic was the fact that they provided annual

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<sup>12</sup> These five companies were Funan International Trust & Investment Company, Shuxing Trust & Investment Company, Zheqiong Trust & Investment Company of Haikou City, Huaxia Financial Company of Haikou City and Jiya Trust & Investment Company of Sanya City.

<sup>13</sup> Calla Wiemer & Heping Cao, *Asian Economic Cooperation in the New Millennium: China's Economic Presence*, 282 (World Scientific Publishing Co. Pte. Ltd. 2004).

<sup>14</sup> Wenyong Wu, *Study on State Aid Legal Systems of Market Exit Mechanisms of Financial Institutions 101*, CHINA UNIVERSITY OF POLITICAL SCIENCE AND LAW PRESS (2012) [in Chinese]. The exchange rate of Renminbi to dollar is approximately 0.12 from 1995 to 2000.

<sup>15</sup> *Id.* at 102.

interest rates as high as 20% to attract depositors. When HDB, as their successor, failed to pay high interest rates, serious liquidity risk problems hounded the doomed bank. In February 1998, rumor spread that HDB would soon be bankrupt. Depositors quickly withdrew their deposits from HDB. Despite the fact that local government officials hastened to deny the distress of HDB, a sizeable bank run was already unavoidable.<sup>16</sup>

In fact, the PBOC had been furnishing HDB with financial assistance since its establishment. In December 1996, HDB was approved to issue a special financial bond equal to 0.5 billion RMB to cover a liquidity shortfall.<sup>17</sup> In 1997, the PBOC provided emergency aid amounting to 3.15 billion RMB to support HDB, which was even allowed to utilize the entire value of its reserves.<sup>18</sup> In 1998, the PBOC again approved HDB to issue a bond of 0.9 billion RMB in February and another bond of 0.5 billion RMB in April, both of which failed to ease the liquidity risk.<sup>19</sup> Meanwhile, HDB was licensed to establish new branches outside Hainan Province to absorb capital. However, all of the above attempts only prolonged HDB's last gasp before it finally met its doom. In June 1998, the PBOC administratively closed HDB, and ICBC assumed all of HDB's assets and liabilities.

The failure of HDB was a typical case illustrating how the central bank and local government acted as full guarantors to compensate for the losses of a bank when an explicit DIS was absent. From its establishment to its closure, HDB operated as a shadow of the local government, aiming to reorganize numbers of distressed firms with poor assets. Sound corporate governance structures and internal control mechanisms had never been set up. Following the administrative closure of HDB, substantial amounts of public funding had been injected to pay out depositors and other individual creditors. However, due to the lack of applicable bankruptcy laws and viable liquidation procedures, HDB remains an open case to this today.<sup>20</sup>

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<sup>16</sup> *Id.* at 102; see also Michael Faure & Jiye Hu, *Towards a Deposit Guarantee Insurance in China? A Law and Economics Perspective*, 1(2) CHIN. J. COMP. LAW. 256, 260-261 (2013).

<sup>17</sup> Hua Liu, *Enlightenment of the Hainan Development Bank's Close Down*, 2 THE BANKER 23 (2004) [in Chinese].

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Ever since the closure of the HDB, authorities never stop their efforts in bringing it



### B. The Rescue of the “Big-Four” Banks

While the Big-Four banks have made great contributions to maintaining financial stability in China, they also have aggregated huge risks.<sup>21</sup> At the end of the 1990s, non-performing loans (NPLs) of the Big-Four banks exceeded 3.2 trillion RMB, representing a serious threat to China’s financial market and the economy.<sup>22</sup>

The potential risks inherent in the long-existing NPLs compelled the government to step up its efforts to tackle the problem. In 1998, the Ministry of Finance (MOF) injected 270 billion RMB into the Big-Four banks through issuing special treasury bonds.<sup>23</sup> As a direct result of this infusion, the capital adequacy ratio of each of the Big-Four banks immediately reached 8% by the end of 1998, surpassing the threshold requirement under the Basel accord.<sup>24</sup> However, the liquidity support failed to bring about anticipated improvement of the Big-Four banks, as they did not make significant changes with their management systems and lending patterns. Large amounts of NPL’s were again accumulated within the Big-Four banks. In 1999, drawing on the United States’ experience in establishing the Resolution Trust Corporation to resolve financial firms’ bad assets, China established four asset management companies (AMCs) to manage and dispose of the NPLs in the Big-Four banks.<sup>25</sup> Hence, China Cinda Asset

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back to life through, for example, proposing reorganization plan. However, due to the lack of bank insolvency laws, huge amounts of debts and non-performing loans of the HDB have still not been effectively addressed and thus the HDB has still not been declared bankrupt.

<sup>21</sup> Each of the Big-Four banks traditionally have been designated to provide specific financial assistance for a particular sector of state economy or for specific state-owned enterprises, which tended to make them suffer severe losses and non-performing loans gained quickly. See Daniel L. McCullough, *Feeling the Stones: Measuring the Potential of Deposit Insurance in China through a Comparative Analysis*, 11 N.C. BANKING INST. 421, 423-25 (2007) (discusses the poor lending practices of the Big-Four Banks).

<sup>22</sup> Liming Li & Renxiong Zeng, *Big Changes of China Finance from 1979-2006* 18 (Shanghai People’s Press 2007) [in Chinese].

<sup>23</sup> Jing Leng, *China’s Banking Reform in the Context of Globalization and Transition*, 17(5) EUR. BUS. L. REV. 1271, 1281 (2006).

<sup>24</sup> *Id.*

<sup>25</sup> The RTC was a U.S. asset management company charged with liquidating assets that had primarily been assets of savings and loans associations declared insolvent during the Savings & Loans crisis of 1980s. In 1995, its duties were transferred to the Savings Association Insurance Fund (“SAIF”) of FDIC. In 2006, the SAIF and the Bank Insurance Fund, which was also sponsored by the FDIC, were together combined to form the Deposit Insurance Fund under the Federal Deposit Insurance Reform Act of 2005. See Lee Davison, *Politics and Policy: The Creation of the Resolution Trust Corporation*, 17,

Management Corporation, China Huarong Asset Management Corporation, China Orient Management Corporation, and China Great Wall Management Corporation were established for the purpose of taking over the NPLs of each of the Big-Four banks, respectively. The four AMCs initiated three rounds of NPL take-overs in 1999, 2004 and 2005, with the total amounts of stripped NPLs exceeding 2.8 trillion RMB.<sup>26</sup> Officially, according to the CBRC, the NPL resolution through the establishment of the AMCs worked efficiently, as statistics showed that the Big-Four banks' bad loans stood at a reduced total of 1.57 trillion RMB and the banks' average NPL ratio dropped to 15.6% at the end of 2004.<sup>27</sup> But it was also undeniable that rather than resolving existing problems, the establishment of AMCs stimulated new bad assets and critics. For example, the AMCs had been criticized for low recovery rates and had even been accused of selling state assets at bargain prices.<sup>28</sup> Public bailouts were still the unavoidable mechanism of choice to save the Big-Four banks, despite the government's repeated warnings that every bailout plan was their last "free supper."

Serious problems had emerged in the resolution process of the Big-Four banks' NPLs that exposed significant loopholes in the institutional design of China's financial system. The Big-Four banks could undoubtedly be categorized as institutions "too big to fail." Hence, the expectation of governmental assistance profoundly reinforced their motivation to conduct even riskier behaviors. The moral hazard resulting from that implicit guarantee exposed taxpayers to unacceptable risks and distorted the level playing field between the Big-Four banks and comparably smaller institutions.

### **C. The Resolution of Rural/Urban Credit Cooperatives**

The rural credit cooperatives (RCCs) were established before the founding of the People's Republic of China (PRC) in 1949. When the RCCs were reintroduced in 1951, they developed quickly and greatly promoted the restoration of the rural economy. The urban credit cooperatives (UCCs) were created after the RCCs, and after the establishment of the first UCC in Luohe

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FDIC BANKING REV., No.2 (2005).

<sup>26</sup> Wu, *supra* note 14, at 79-80. See also Guonan Ma, *Sharing China's Bank Restructuring Bill*, CHINA & WORLD ECONOMY Vol. 14, No. 3, 2006, <https://www.bis.org/repofficepubl/apresearch0605ma.pdf>.

<sup>27</sup> Leng, *supra* note 23, at 1281-1283.

<sup>28</sup> *Id.*

County of Henan Province in 1979,<sup>29</sup> UCCs gradually developed as one of the most vibrant layers of China's financial system to animate the market economy. Nevertheless, both RCCs and UCCs had eventually become problematic enough to attract the attention of the regulatory authorities. Some RCCs and UCCs became subsidiaries of their investors, most of which were local governments or state-owned banks and enterprises. The motivation of these investors to engage in activities with RCCs and UCCs was not to assist them to become profitable firms, but to regard them as a tool for realizing their secret ulterior goals, such as arranging job opportunities for their relatives and making easy money. Some RCCs and UCCs operated businesses beyond their licensed scope and even made use of policy loopholes to obtain illegal earnings. Like other small- and medium-sized enterprises (SMEs) facing difficulty in expanding business and gaining profits through normal market strategies, many RCCs and UCCs provided tempting high interest rates to attract depositors. At the end of the 1990s, the official NPL rate for cooperatives was estimated to be 50% of total loans.<sup>30</sup> Low quality of assets and insufficiency of risk management had made the resolution of RCCs and UCCs an urgent priority.

To solve the debt burdens and business strategy problems of credit cooperatives, the PBOC stopped licensing new UCCs. In the institutional reform of 1995, all UCCs were ordered to restructure by one of the following methods: 1) to be acquired by city commercial banks; 2) to be acquired by joint-stock commercial banks; or 3) to merge with RCCs.<sup>31</sup> At the end of 1999, more than 2,300 UCCs were merged with city commercial banks.<sup>32</sup> In 2003, the State Council launched the *Pilot Plan to Deepen the Reform of Rural Credit Cooperatives* to clarify the ownership of RCCs and to put them under the direct supervision of local governments.<sup>33</sup> Moreover, the PBOC provided strong

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<sup>29</sup> Eric Girardin & Xie Ping, *Urban Credit Cooperatives in China*, OECD Development Centre Working Paper No.125, at 41, <http://www.oecd.org/development/pgd/1919655.pdf>.

<sup>30</sup> Wu, *supra* note 14, at 81.

<sup>31</sup> Xuejin Zuo, *The Development of Credit Unions in China* (2001), at 3-4, [http://www.hks.harvard.edu/m-rcbg/Conferences/financial\\_sector/PastFailuresoftheCreditUnion.pdf](http://www.hks.harvard.edu/m-rcbg/Conferences/financial_sector/PastFailuresoftheCreditUnion.pdf) (last visited July 28, 2015).

<sup>32</sup> Che-Cheong Poon, *Rebuilding a Robust Financial Cooperatives System in China: Learning from the Experience of Credit Union movements in Hong Kong and Taiwan*, 3 INT'L J. COOP.STUD., 16 (2014).

<sup>33</sup> The original rule is available at [http://www.gov.cn/gongbao/content/2003/content\\_62255.htm](http://www.gov.cn/gongbao/content/2003/content_62255.htm) (last visited July 28, 2015).

political, financial and fiscal support to RCCs. For example, the PBOC issued targeted loans and commercial papers to RCCs eligible to the pilot plan to help them to remove their historic burdens. The MOF offered government subsidies to RCCs who paid extra interest to inflation-proof savings accounts due to the implementation of the pilot plan.<sup>34</sup> From 2003 to 2005, corporate income taxes were completely exempted for all pilot RCCs in western areas of China, and half exempted for pilot RCCs in other areas. While these efforts to reorganize RCCs and rural financial systems had, to some extent, moderated the deficits of RCCs, the costs were considerable. As part of the 2003-2005 reform package, the PBOC provided 168 billion RMB conditional debt-for-bills swaps and 830 million RMB earmarked central bank loans to assist RCCs to clear up debt burdens and toxic loans.<sup>35</sup>

It appears that among the most plausible reasons why Chinese authorities stepped in to resolve RCCs and UCCs' issues was the desire to preserve the "diversity value" of the banking system and to promote financial inclusion, so that SMEs, as well as vulnerable individuals like low-income farmers and workers, could receive equal access to financial services and sufficient protection of their savings. In order to propel the development of micro-financial services in rural areas, China established the "Rural Mutual Cooperative" (RMC) in 2007, a new type of cooperative that was intended to operate as a fund-raising organization in rural communities.<sup>36</sup> Judging from their market performance, RMCs still, to a large extent, rely on governmental funding. Hence, a question is quite outstanding here: do bailouts in the name of promoting financial inclusion actually achieve their goals, or do they worsen regulatory incentives?

The cases discussed above make manifest that both large state-owned banks, like the Big-Four banks, and small institutions, like local commercial banks, RCCs and UCCs, benefited from the controversial guarantee provided by the government. This was fairly reasonable, as China had been operating an extremely unified financial system. Before the financial reform of 1979, although

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[in Chinese].

<sup>34</sup> Wu, *supra* note 14, at 82.

<sup>35</sup> Lynette Ong, *Prosper or Perish: Credit and Fiscal Systems in Rural China*, 43 (Cornell University Press 2012).

<sup>36</sup> *CBRC Interim Provisions on the Administration of Rural Mutual Cooperatives*, Jan. 2007, <http://www.lawinfochina.com/display.aspx?lib=law&id=5852&CGid> (last visited June 27, 2015).

new banks like CCB and ABC had been established, they were largely subordinated to the PBOC, and even the PBOC had been incorporated into the MOF in 1969.<sup>37</sup> Under this unified scheme, banks were affiliates of a very strong central government that directed the banks fund-raising, internal management, profits and losses, as well as all other aspects of ongoing operations. Following the “Reform and Open” policy set forth in 1978, China began to reorganize its financial system and gradually headed towards marketization reform, but the defects of the old financial system were difficult to correct overnight. As estimated by a senior official of the PBOC in 2006, the gross domestic product (GDP) of China in 2005 was about 15 trillion RMB, by which time the government had spent 5 trillion RMB in saving failed financial institutions. This means that one-third of the nation’s GDP had been offset by financial bailouts.<sup>38</sup>

While implicit DIS had played an important role in maintaining China’s financial and social stability in the transitional period from planned economy to market economy, its disadvantages are outstanding. The government has absorbed enormous amounts of costs in paying for the losses of financial institutions, which will inevitably be passed on to taxpayers. The prospects of overall government bailouts strengthen the incentives of financial institutions to pursue riskier activities to obtain higher profits. As we retrospectively review the evolution of the HDB and other SMEs, we notice that the reasons for their failures were strikingly similar, and one of the most dominant being the use of high interest rates to attract depositors and the simultaneous neglect regarding risks of timely reimbursement. Regulators frequently resort to bailouts instead of letting financial institutions collapse into bankruptcy out of fear that the losses generated by a failure would cascade through the financial system, freeze the financial market, and ultimately stop the economy. However, it is necessary for regulators to achieve a delicate balance in the role they play in financial supervision. On one hand, it is their crucial task as the lender of last resort to promote confidence and stability through funding guarantees; on the other hand,

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<sup>37</sup> Wu, *supra* note 14, at 84.

<sup>38</sup> Jiao Jinpu (焦瑾璞), *Jianli Guifan de Shichang Tuichu he Jianguan Xietiao Jizhi* (建立规范的市场退出和监管协调机制) [*Establishing Market Exit and Regulatory Coordination Mechanism*], SOHU FIN. (Apr. 23, 2006, 3:35PM), <http://business.sohu.com/20060423/n242951481.shtml>.

it is equally important that they uphold regulatory discipline through prudent supervision and strengthen market discipline by making clear the limits of the extent of government aid.

## II. EXPLICIT DEPOSIT INSURANCE: A PREREQUISITE FOR PROPELLING FURTHER REFORMS

Along with the implementation of the implicit DIS, China has consistently made attempts to establish an explicit DIS. The earliest attempt can be traced back to 1993, when the State Council put forward *The Decision on the Reform of the Financial System* (the Decision) and made the first formal announcement that China should adopt a DIS.<sup>39</sup> In 1997, a task force on deposit insurance was created to research the viability of an explicit DIS in China. After several years of work, in 2003, the task force issued a report outlining some key issues concerning the establishment of a DIS, including the steps and timeframe to transition from an implicit DIS to an explicit one, the methodology to deal with moral hazards, the institutional design of the DIS, and so on.<sup>40</sup> By the end of 2007, a draft DIS rule had been passed on to relevant ministerial departments for legislative review, but the onset of the global financial crisis delayed the process. In the post-crisis era, China had re-promoted the agenda for the establishment of a DIS. In November 2013, as stated in its Introduction, the Decision reiterated the determination of the Chinese government to establish an explicit DIS as a sound mechanism to prevent systemic risks, and set a deadline for its establishment. The *Report on the Work of the Government of 2014* articulated that China intends to “deepen reform of the financial sector and establish a DIS and improve [the] risk disposal mechanism of financial institutions.”<sup>41</sup> In November 2014, the

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<sup>39</sup> Guowuyuan Guayu Jinrong Tizhi Gaige de Jueding (国务院关于金融体制改革的决定) [Decision of the State Council on Reform of the Financial System] (promulgated by the St. Council., Dec. 25, 1993, effective Dec. 25, 1993), ASIAN LEGAL INFO. INST., <http://www.asianlii.org/cn/legis/cen/laws/dotscorotfs549/>. The principal debate over the necessity of introducing deposit insurance in China at that time was whether banking industry should be competitive. Many held that banking industry is a core national economic sector thus needed full governmental backup. But gradually Chinese authorities realized that monopoly in banking industry would devastate market environment and jeopardize financial consumer interests, and therefore, competition should be enhanced. See Bing Xu et al., *Measuring Banking Competition in China: A Comparison of New versus Conventional Approaches Applied to Loan Markets*, Bank for Int'l Settlements Working Papers No. 422, 6-10 (2013), <http://www.bis.org/publ/work422.pdf>.

<sup>40</sup> Task Force Team of People's Bank of China, *Some Thinking on Building up a Deposit Insurance System in China* (2003) 5 CHINA FIN, at 17 [in Chinese].

<sup>41</sup> Keqiang Li, *Report on the Work of the Government*, Xinhuanet (Mar. 16, 2014

revised draft DIS was proposed to call for public consultation.<sup>42</sup> Eventually, the State Council approved the Regulation on DIS in March 2015.

The timing of the establishment of the DIS is quite tactical, focusing on a period when China's economy is less robust and the speed of development is slowing down. At such time, there is potentially a greater risk of banks encountering a liquidity crisis. The gradual establishment of shadow banking and the private lending crisis also makes the DIS an indispensable shield to resist the ever-increasing systemic risks in the banking sector. At the same time, while the Chinese government has been constantly advancing financial innovation and easing administrative controls over the financial industry, China's financial market is still largely viewed as highly predominated by governmental policies and, therefore, further reforms are necessary to more profoundly free the financial market and develop a more diversified banking structure. In this regard, the establishment of the DIS is deemed a prerequisite to further other co-initiated financial reform goals, including removing remaining controls on interest rates and increasing the role of market forces in the financial industry's operation so that banks are allowed to fail if they are not well-operated or if they contain too many risks. Judging from the status quo of China's financial market and examining the ambitious goals of China's financial reform agenda, it can be concluded that establishing a formal DIS is an urgent priority for China.

#### A. Interest Rate Marketization

“Interest rate marketization” refers to the removal of administrative restrictions on interest rates and their fluctuations, and allowing the supply-demand

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8:05PM), [http://news.xinhuanet.com/english/china/2015-03/16/c\\_134071473.htm](http://news.xinhuanet.com/english/china/2015-03/16/c_134071473.htm).

<sup>42</sup> Guowuyuan Fazhi Bangongshi Guanyu Cunkuan Baoxian Tiaoli (Zhengqiu Yijian Gao) Gongkai Zhengqiu Yijian de Tongzhi (国务院法制办公室关于《存款保险条例(征求意见稿)》公开征求意见的通知) [Public Notice for Comments from the Legislative Office of St. Council on Regulation of Deposit Insurance (Draft)], St. Council Gaz., Nov. 30, 2014, <http://www.chinalaw.gov.cn/article/xwzx/tpxw/201411/20141100397756.shtml>. The PBOC released the Cunkuan Baoxian Tiaoli (Zhengqiu Yijian Gao) (存款保险条例(征求意见稿)) [Regulation of Deposit Insurance (Drafted Version for Comments) and Zhongguo Renmin Yinhang Guanyu Cunkuan Baoxian Tiaoli (Zhengqiu Yijian Gao) de Shuoming (中国人民银行关于《存款保险条例(征求意见稿)》的说明) [Instructions on the Draft Regulation of Deposit Insurance System by the PBOC] (the “Instructions”), and Cunkuan Baoxian Zhishi Zhuanjia Wenda (存款保险知识专家问答) [Q&A about Deposit Insurance] (the “Q&A”), as further clarifications/ background information to make sure that the public fully understand the contents and the rationale of the proposed DIS.

mechanism to play a determinant role in deciding their structure. China's bank deposit and lending rates have subject to stringent restrictions for a long time. While this may have been reasonable when China was under the planned economy regime, restrictions on interest rates have significantly impeded the competitiveness of China's banking industry with the advance of financial reform, especially considering that most banks, including the Big-Four banks, have completed their joint-stock system transformations and become listed banks.

Policymakers have set forth clear intentions to open China's capital markets and to halt direct policy interventions in setting interest rates. Basically, interest rate marketization in China has adopted a three-step development strategy, from the liberalization of the money market gradually moving to that of the bond market and to deposit and lending rates. As early as 1996, the PBOC promulgated *The Decision on Removing the Cap on Inter-bank Borrowing Interest Rates*, marking an initial step towards liberalization of interest rates.<sup>43</sup> Meanwhile, China conducted deepened marketization reform on the issuance of national bonds and the removal of caps on the inter-bank bond market interest rate. The big moment came on October 29, 2004, when the PBOC completely removed the upper limit of the lending rate and the lower limit of the deposit rate, symbolizing that China achieved its interim goal along the path towards interest rate marketization.<sup>44</sup>

At a conference in November 2014, Hu Xiaolian, the former Deputy Governor of the PBOC, announced that, since the beginning of 2014, important measures had been taken to promote market-based interest rates:

The floating range of deposit rates was expanded from 1.1 times to 1.2 times benchmark rates. Moreover, the maturity brackets of deposit and lending interest rates were simplified to provide more space for market pricing of interest rates, and to improve the Shanghai inter-bank lending rate and market interest rate self-regulatory pricing mechanism.<sup>45</sup>

In June 2015, with the floating range of deposit rates rising up to 1.5 times

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<sup>43</sup> The People's Bank of China, *Report on Steady Progress in Market-based Interest Rate Reform, Supplement to the China Monetary Policy Report* (Jan. 2005), <http://www.pbc.gov.cn/english/130721/2831321/index.html>.

<sup>44</sup> *Id.*

<sup>45</sup> The People's Bank of China, *Speech at the Annual Meeting of the Caijing Magazine Deputy Governor Hu Xiaolian* (Dec. 16, 2014), <http://www.pbc.gov.cn/english/130721/2873242/index.html>.



benchmark rates, the full completion of interest rate marketization was almost realized.<sup>46</sup>

International experience has shown that in the course of interest rate liberalization, many economies have undergone fluctuations or even financial crises. There were some successful examples like the United States, Japan, Korea, but also failed ones in some Latin American countries. In the United States, a maximum deposit rate under “Regulation Q” was created in response to the Great Depression.<sup>47</sup> Beginning in the late 1960s, as the inflation rate increased rapidly, negative interest rates and financial disintermediation became very serious. In the 1970s, inflation caused the interest rates to rise above the limits mandated by Regulation Q, investors started to seek out alternatives to traditional deposit accounts. Money market funds were created to pool small investors’ funds to purchase commercial paper. These money market funds operated without reserve requirements or restrictions on rates of return and thus soon became popular among small investors. With the aim of allowing banks and savings and loans to compete with money market funds, the *Depository Institution Deregulation and Monetary Control Act* was enacted in 1980, whereby the Federal Reserve gradually removed the restrictions of “Regulation Q.”<sup>48</sup> In 1986, when the upper limit of the interest rate of a Negotiable Order of Withdrawal (NOW) account<sup>49</sup> was removed, the United States basically completed its interest rate marketization.

The beginning of Japan’s official process of interest rate liberalization can

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<sup>46</sup> *China may free up bank deposit rates soon: central bank official*, Reuters (Jun 3, 2015 10:09 PM), <http://www.reuters.com/article/2015/06/04/us-china-economy-rates-idUSKBN0OK05I20150604>.

<sup>47</sup> Regulation Q was created by the Banking Act of 1933 to prohibit the payment of interest on demand deposits and to impose interest rate ceilings on various other types of bank deposits, i.e. savings and time deposits. Regulation Q no longer exists now, all remaining aspects of the regulation have been incorporated into Regulation D. See R. Alton Gilbert, *Requiem for Regulation Q: What it Did and Why it Passed Away* FED. RES. BANK OF ST. LOUIS REV. 22-37 (1986), [https://research.stlouisfed.org/publications/review/86/02/Requiem\\_Feb1986.pdf](https://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf).

<sup>48</sup> Wei Liao & Sampawende J.-A. Tapsoba, *China’s Monetary Policy and Interest Rate Liberalization: Lessons from International Experiences*, International Monetary Fund Working Paper WP/14/75, 10 (2014), <https://www.imf.org/external/pubs/ft/wp/2014/wp1475.pdf>.

<sup>49</sup> Negotiable Order of Withdrawal Accounts, 12 C.F.R. § 390.297 (2015). (A NOW account is a deposit account that pays interest on which an unlimited number of checks may be written).

be traced back to the establishment of an ad hoc Yen/Dollar Committee between the Japanese Ministry of Finance and the US Treasury in late 1983, which was set up against the background of a large and widening trade imbalance between the country.<sup>50</sup> In March 1985, Japan signed with the United States a *Yen/Dollar Report*, which outlined important measures for Japan to deregulate its financial market, including reforms like the removal of the upper limit of the fixed term deposit interest rate and the removal of caps on the wholesale deposit interest rate.<sup>51</sup> Simultaneously, the MOF of Japan issued a report entitled *The Present Status of and Prospects for the Deregulation of Finance and Internationalization of the Yen*, in which the MOF emphasized the desirability and merits of financial liberalization and internationalization of the yen.<sup>52</sup> By October 1994, Japan basically achieved interest rate marketization.

Both the United States and Japan adopted a phased-in model to propel their interest rate reform, which was accompanied by the development of financial innovation and the expansion of direct financing. Nevertheless, interest rate marketization also significantly influenced financial stability. As the financial market became more liberalized, many financial institutions engaged in riskier activities to gain higher profits. Taking the United States as an example, the banking business changed considerably during the 1980s as risks increased due to increased volatility of interest rates, as well as exchange rates. From 1982 through 1991, more than 1,400 Federal Deposit Insurance Corporation (FDIC) insured banks failed, including 131 that remained open only through FDIC assistance.<sup>53</sup> However, with the enactment of *The Financial Institution Reform, Recovery and Enforcement Act (FIRREA)* in 1989, as a major reform of the national DIS, the deposit insurance fund was reorganized and the insurance coverage was expanded.<sup>54</sup> The United States eventually came out of the Savings and Loans (S&L) Crisis and entered a new era of financial development.

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<sup>50</sup> Shinji Takagi, *Internationalising the Yen, 1984-2003: Unfinished Agenda or Mission Impossible*, in CURRENCY INTERNATIONALISATION: LESSONS FROM THE GLOBAL FINANCIAL CRISIS AND PROSPECTS FOR THE FUTURE IN ASIA AND THE PACIFIC, 77 (2011),

<sup>51</sup> *Id.*

<sup>52</sup> RICHARD B. FINN, U.S. – JAPAN RELATIONS: A SURPRISING PARTNERSHIP 83 (TRANSACTION PUBLISHERS, 1986).

<sup>53</sup> Federal Deposit Insurance Corporation, A Brief History of Deposit Insurance in the United States 50 (1998), at <https://www.fdic.gov/bank/historical/brief/brhist.pdf>.

<sup>54</sup> Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, 103 Stat. 183 (1989), <http://legisworks.org/GPO/STATUTE-103-Pg183.pdf>.

Comparatively, Japan established its DIS in 1971, several years prior to its full implementation of interest rate liberalization in preparation for offsetting instabilities.

As the PBOC stated, deposit interest rate marketization would be completed in the next one or two years as a critical change of China's financial infrastructure, since it would allow banks to offer higher interest rates to attract funds that have recently been going into the riskier shadow banking system. This institutional change was proposed as the final stage in the long-running financial reforms that have sought to wean China off investment-driven growth that depositors have subsidized in the form of low deposit interests. However, lessons drawn from international practice affirm that deposit interest rate liberalization will not land softly in China unless the DIS is established *ex ante*. A well-designed DIS can help spur interest rate liberalization, especially involving the still-regulated deposit rates, thereby encouraging innovation and providing more options for consumers.

#### **B. Private Bank Pilot Program**

China has long been criticized for its highly concentrated banking sector that is dominated by state-owned banks. Because the Xi Jinping Administration is pushing changes that may be the most sweeping since Deng Xiaoping's liberalization in 1978 to loosen government controls over the banking industry, China's banking sector will perhaps embrace a fundamental change in the near future. In March 2014, during the period of Lianghui,<sup>55</sup> Chinese policymakers approved a pilot program to establish five privately-owned banks as the government sought to ease restrictions on the state-controlled banking industry. According to the CBRC, China would allow these five banks to be set up in the cities of Shanghai and Tianjin, and in provinces of Guangdong and Zhejiang, all of which are developed areas in China. Alibaba Group Holding Ltd., Tencent Holdings Ltd. and other privately-owned commercial tycoons are among the private companies chosen to participate in this program.

The program will follow the principle of co-sponsors, which requires every pilot bank to have at least two initiators. According to the CBRC, the selection

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<sup>55</sup> Chinese National Lianghui (两会) [Two Sessions] is the period when the Annual Meetings of the National Peoples' Congress and the Chinese People Political Consultative Conference are hosted together in Beijing.

criteria of the five pilot banks are neither quota distribution under the planned economy context, nor regional division under administrative management, but “selecting [the] best of the best” from around the nation.<sup>56</sup>

In January 2015, the first two of the five pilot banks started their business. The first one was WeBank, co-sponsored by Chinese Internet giant Tencent and two other local firms in Shenzhen, which is the first online-only private bank in China, named after Tencent’s popular mobile communication app, “WeChat.” WeBank will have limited physical branches, with all of its consumer access, risk controls and business management conducted online, and it expects that most loans issued will be less than 1 million RMB. The intention is to avoid making WeBank operate like traditional banks that own an enormous physical network with a large balance sheet. The second pilot bank was Shanghai Huarui Bank, which is registered in the Free Trade Zone (FTZ) of Shanghai with a capital of 3 billion RMB. The bank is approved to conduct a full range of banking services, including deposits, lending, banking card issuance, foreign exchange, and bonds, but it will mainly be aimed at serving small businesses in the FTZ. Both of these newly approved private banks will make it easier for SMEs and entrepreneurs to obtain loans. By June 2015, all other three pilot banks were established, including Minshang Bank and Wangshang Bank in Zhejiang Province, and Jincheng Bank in Tianjin.

In the long run, the establishment of private banks in China will have significant implications. First, it will make the entry into the banking market more flexible and will push structural reform of China’s banking industry. The establishment of private banks will attract private capital into the current state-dominated banking sector and accelerate restructuring and ownership reform of the banking industry. Second, it will lower the costs for and deliver practical benefits to small and medium clients. SMEs have become an important impetus to China’s economic growth, but they have always faced fund-raising

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<sup>56</sup> The PBRC’s major considerations are: first, the bank should have institutional arrangements to bear residual risks; second, the bank should have good qualifications and anti-risk ability; third, the bank should have a sound internal corporate governance mechanism; fourth, the bank should have differentiated market positioning and specific strategies; fifth, the bank should have feasible risk resolution and recovery plan. *See Name List of the First Group of Pilot Private Banks at Their Own Risks Publicized*, CHINA BANKING REGULATORY COMM’N., <http://www.cbrc.gov.cn/EngdocView.do?docID=C309C49961B44D1B9704CA1CAA24ED9E> (last visited June 7, 2015).

problems as banks traditionally prefer lending to state-owned and larger enterprises. In bidding for the pilot program, many participating private companies put forward a “small deposit, small lending” business motto, stating that the private banks would mainly serve the needs of SMEs and local communities. Hence, it can be expected that fund-raising for them would be easier in the future. Third, it will encourage financial innovation and provide diversified banking services. For instance, WeBank’s decision to operate its business online will promote the development of internet finance and increase public access to financial services.

There is a blueprint ahead of China’s ambitious agenda to restructure its banking sector; however, the pilot program may become a dangerous trial if the DIS is not in place. While market reactions to the establishment of private banks are basically positive, there are still concerns over unsound corporate governance, insufficiency of management capability, and risk control ability that private banks may be confronted with. It is also possible that pilot banks can become financing tools of their shareholders, incentivizing them to pursue riskier activities. Therefore, the CBRC has been very cautious when pushing forward the pilot program, and declares that it will implement strong prudential regulation over already established private banks in accordance with state laws and international standards. Meanwhile, the CBRC underscores the importance of establishing risk management mechanisms to protect depositors and the significance of creating resolution arrangements to make sure that if risks occur, private banks can be closed in an orderly manner.<sup>57</sup>

Technically, the DIS was launched before the establishment of private banks, which revealed Chinese policymakers’ concerns over the indifferentism and skepticism of depositors who would have shown little interest or would have casted doubts on the accountability of those banks. *De facto*, the launch of the DIS is not only a signal to the public that China is about to accelerate its reforms

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<sup>57</sup> The pilot banks must have adequate net capital, a specific business strategy and a mechanism to prevent risks from spreading to protect depositors’ interests. They also need to enact “living wills ” designed to ensure an orderly wind-down if going into bankrupt. “Living Wills” are proposed by specific financial institutions as a risk resolution mechanism established prior to occur of a failure. “Living Wills” are also called “Resolution Plans” and are created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §165, 124 Stat. 1376 (2010).

towards a more diversified and inclusive banking industry, but also a precondition for the pilot program to work. The DIS alleviates small depositors' panic and hesitation about private banks in that it provides them with adequate confidence that they will be equally reimbursed, just as when they use the big banks. Without the deposit insurance in place, Chinese depositors would have very limited incentives to try new out entrants, potentially dooming the reform efforts of the pilot program before it even starts.

### C. Market Exit Mechanism for Financial Institutions

Related to the liberalization of the interest rate and the implementation of the private bank pilot program is the increasing possibility of bank failures in the near future. Especially when all of these reforms are undertaken at the same time, risks will accumulate rapidly in a short timeframe and China's financial market is not mature enough to resist these impacts. Judging from the HDB case, the rescue of the Big-Four Banks and other bailout phenomenon that was previously discussed, it is evident that China has not been able to set up a formal legal framework to resolve failures of financial institutions. Because bailouts have become increasingly costly nowadays and considering that still more private banks are being set up, it would be impossible for the government to bear losses of all these firms. Following the establishment of a DIS, setting up a market-based exit mechanism for financial institutions will be the next goal in China's financial reform agenda.<sup>58</sup>

So far, China's attempts to establish a market exit mechanism have not been very successful. The main legislative bases for dealing with failures of financial institutions are the *Regulation on Closure of Financial Institutions*, which was proposed in 2001, and the *Regulation on the Risk Disposal of Securities Companies*, which was launched in 2008. Both of these regulations were promulgated by the State Council and are thus inferior to laws promulgated by the Standing Committee of the National People's Congress.<sup>59</sup> However, existing

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<sup>58</sup> China.org.cn, *supra* note 8.

<sup>59</sup> The hierarchy of China's legislations are: Constitution, Laws enacted by NPC, Administrative Regulations by the State Council, Local People's Congress Regulations by local people's congresses at provincial level, other rules and ordinances, including central-level ministries, agencies and commissions directly under the State Council, and then local-level governments. See Jingjing Liu, *Overview of the Chinese Legal System*, ELR CHINA UPDATE, Issue 1, Jan.-Mar. 2013, 1, <http://elr.info/sites/default/files/chinaupdate1.1.pdf>.

laws, such as the *Enterprise Bankruptcy Law*, the *Commercial Banks Law*, and the *Law of Regulation of and Supervision over the Banking Industry*, surprisingly remain silent about the procedures for risk prevention and resolution of financial institutions. Moreover, the two-abovementioned regulations are inadequate because they only outline a rough picture of the closure procedures of banks and securities companies, as well as the related administrative responsibilities and mandates of policymakers. Furthermore, the two regulations mistakenly overlook perhaps the most important issues in risk resolution: effectively reimbursing vulnerable financial consumers like individual depositors, and making culpable institutions bear losses for their failures while keeping the continuity of fundamental financial functions. One of the reasons explaining this is, conspicuously, the lack of a marketized DIS.

Due to the banking sector's fundamental significance in the financial industry, preferential considerations have been given to the design of a market exit mechanism for banks in China, which is also regarded as the bank insolvency regime led by the CBRC.<sup>60</sup> The functioning of the bank insolvency regime is closely related to the effectiveness of the DIS. The HDB case showed that a bank run always occurs before the bank is doomed to be unresolvable. The rumors of bank failure and the fear of depositors often incentivize them to withdraw money in a short time, exacerbating the bank's operating conditions and reducing its prospects of being orderly resolved under a bank insolvency regime. Essentially, without a clear-set DIS in place, many resolution techniques designed in the bank insolvency regime may not even have chance to be implemented.

A perfect example demonstrating how the DIS works seamlessly with a bank insolvency regime comes from the United States. The FDIC is not only a deposit insurer, but also a key architect responsible for bank insolvency. Before closing a failed bank and paying out depositors, the FDIC has a number of grounds to verify the resolvability of the bank. One of the most explicit grounds

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<sup>60</sup> The current bank rescue techniques used by the CBRC are recapitalization, mergers, closure and debt-to-equity conversion, among others. The CBRC has been considering enacting the Regulations on Bank Insolvency since 2005, when the third round of NPL taking-over of the Big-Five banks were implemented. The establishment of the DIS paves way for the CBRC in its future efforts in designing such a scheme. See Ping Xie, *Bank Restructuring in China*, BIS Policy Paper No.6, 124-129 (1999), <http://www.bis.org/publ/plcy06.pdf>.

is the capital-based condition under the “prompt correction action” (PCA), adopted in the *Federal Deposit Insurance Corporation Improvement Act* (FDICIA) in 1991. According to this rule, a bank should become subject to additional supervisory requirements if its capital continues to decline, and when the capital is just equal to or less than 2% of its total assets, it will be defined as “critically undercapitalized.”<sup>61</sup> Once such a decision is made, a conservator or receiver should be appointed within 90 days unless the bank returns to going-concern values.<sup>62</sup> Two 90-day extensions of the PCA period can be granted if the FDIC believes that these extensions would better protect relevant shareholders or reduce losses of the deposit insurance fund (DIF).<sup>63</sup>

Early intervention measures, like the PCA, are important characteristics of the American bank insolvency regime. Moreover, under the *Federal Deposit Insurance Act* (FDIA), the FDIC has complete power over the assets and liabilities of the failed bank as soon as the FDIC is appointed as receiver.<sup>64</sup> This power allows the FDIC to arrange an immediate sale of assets and transfer insured deposits to other banks. Such immediate sales limit the impact of the failure on depositors, and since the FDIC is immediately vested with full ownership over the assets, it can complete a sale as part of the initial resolution or shortly afterward without awaiting court, creditor or shareholder approval. The policy goal is to provide the FDIC with adequate authority and flexibility in maximizing the prospects of recovery for the benefit of depositors and other creditors. From this brief overview, we can see that there are no clear boundaries between the DIS and the bank insolvency regime in the United States, and together they form a coherent risk prevention and resolution framework for banks and other depository institutions.

The necessity of establishing a bank insolvency regime in China further compels the launch of the DIS, and the unveiling of the DIS is a strong sign foreshadowing the launch of a formal bank insolvency regime in the very near

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<sup>61</sup> 12 U.S.C. § 1831o(b)(1)(E). In 12 U.S.C. § 1831o(b)(1), FDICIA required federal regulators to establish 5 capital levels ranging from “well-capitalized” to “critically undercapitalized.” These levels serve as the basis for PCA and, as the capital level declines, the regulators can impose increasingly stringent controls on the institution. Those controls may include limits on deposit taking and other business restrictions..

<sup>62</sup> 12 U.S.C. § 1831o (h)(3)(A).

<sup>63</sup> 12 U.S.C. § 1831o (h)(3)(C).

<sup>64</sup> 12 U.S.C. § 1821(d)(2).



future, perhaps in 2016. Because the legislative work of the two regimes are led separately by the PBOC and the CBRC, potential conflicts between the two regulatory watchdogs may create regulatory loopholes undermining the effectiveness of both regimes. Therefore, there should be further regulations arranging relative issues with respect to authority allocation and regulatory cooperation. Still, no one will deny that the establishment of the DIS has paved the way toward establishing a bank insolvency regime in China.

### III. FUNDAMENTALS OF CHINA'S DEPOSIT INSURANCE AND UNRESOLVED ISSUES

The Regulations contain 23 articles and formulate all basic elements that a formal DIS should have, such as coverage, membership, premium rates and funding arrangements. While the Regulations absorb common beneficial features from deposit insurance schemes of other countries, especially the United States,<sup>65</sup> they also reflect specific circumstances of the current situation of China's financial market. However, compared with schemes in other jurisdictions, the Regulations are obviously too concise, thereby reducing the operability of the proposed scheme and leaving some important unresolved issues that require further clarifications. The key elements of the proposed Regulations are introduced below, followed by a discussion of some issues with the clarity of the elements.

#### A. Governance, Mandates and Powers

Most jurisdictions with an explicit DIS have a governing board type of structure, known as the "deposit insurer." According to a thematic review conducted by the Financial Stability Board (FSB) in 2012, some deposit insurers are dominated by representatives from the government (e.g. Russia), the banking industry (e.g. Argentina, Brazil, Germany), or the supervisor (e.g. Australia).<sup>66</sup> No matter what type of governance is adopted, deposit insurers should enjoy independence as much as possible, both from the banking industry that is insured

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<sup>65</sup> In October 2013, the FDIC and the PBOC signed a Memorandum of Understanding to develop and expand cooperation between the two agencies regarding various aspects of financial regulation, including deposit insurance. See *Memorandum of Understanding between Federal Deposit Insurance Corporation and People's Bank of China Regarding Cooperation, Technical Assistance and Cross Border Resolutions*, FED. DEPOSIT INS. CORP. (Oct. 24, 2013), <https://www.fdic.gov/news/news/press/2013/pr13093a.pdf>.

<sup>66</sup> See Financial Stability Board, *Thematic Review on Deposit Insurance Systems*, Peer Rev. Rep. 46, (2012), [http://www.financialstabilityboard.org/wp-content/uploads/r\\_120208.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_120208.pdf).

and from the financial safety participants and other political influences. To this end, deposit insurers should take a legal structure that allows its governing board to make decisions and realize mandates independently.

Deposit insurers can choose among *ex ante* or *ex post* funding mechanisms. *Ex ante* funding requires the accumulation and maintenance of a deposit insurance fund (DIF) to cover insurance claims and related expenses prior to a failure occurring. A deposit insurance fund is principally formed by insured institutions through contributions, premiums, and other means. In *ex post* funding systems, funds to cover insurance claims are collected from member institutions when they fail and when the need to cover claims develops.<sup>67</sup> *Ex post* systems may be less onerous on member institutions when there are few failures of limited magnitude because less premiums are collected, lowering administrative costs associated with the collection of premiums and fund management.

To date, most jurisdictions have adopted an *ex ante* DIS funding structure and have established deposit insurance funds. The Regulations makes clear from the very beginning that deposit insurance is a system under which insured depository institutions pay premiums to the Deposit Insurance Fund Management Agency (DIFMA), thus forming a deposit insurance fund, and the DIFMA reimburse depositors and take necessary measures to maintain the safety of the deposits and the deposit insurance fund.<sup>68</sup> From this assertion, we know that China also adopted an *ex ante* funding structure. The sources of the insurance fund are: (i) premiums paid by insured institutions; (ii) properties received under liquidation of insured institutions; (iii) income from the utilization of the fund; and (iv) other legitimate income.<sup>69</sup> Article 11 of the Regulations further clarifies that the utilization of the fund should be secure, and should preserve its liquidity and value. Authorized utilization will be limited to: (i) being held by the PBOC; (ii) investing in financial bonds and other senior bonds that have high credit ratings, i.e. government bonds, central bank bills and highly-rated debentures; and (iii) utilizing other methods approved by the State Council.<sup>70</sup>

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<sup>67</sup> Luc Laeven, *Pricing of Deposit Insurance*, World Bank Policy Research Working Paper No. 2871, at 3, at <https://core.ac.uk/download/files/153/6719598.pdf>.

<sup>68</sup> See Cunkuan Baoxian Tiaoli (存款保险条例) [Regulation on Deposit Insurance] (promulgated by St. Council, Oct. 29, 2014, effective May 1, 2015) St. Council Gaz., Mar. 31, 2015, (2015), [http://www.gov.cn/zhengce/2015-03/31/content\\_2840827.htm](http://www.gov.cn/zhengce/2015-03/31/content_2840827.htm).

<sup>69</sup> *Id.*, art. 6.

<sup>70</sup> *Id.*, at art. 11.

According to the Regulations, the DIFMA will be established as the primary agency responsible for the operation of the deposit insurance fund.<sup>71</sup> The Regulations do not clarify the formation, structure or administration of the DIFMA but states that all such issues will be decided by the State Council. However, the Regulations do set out responsibilities that the DIFMA will have, including: (i) formulate and publish rules related to the fulfillment of their mandates; (ii) formulate and adjust the criteria of premiums rates and refer to the State Council for approval; (iii) determine the applicable rates of each insured institution; (iv) collect premiums; (v) administer and utilize the deposit insurance fund; (vi) undertake early corrective actions and risk resolution measures; (vii) reimburse depositors timely; and (viii) carry out other mandates approved by the State Council.<sup>72</sup>

Moreover, the DIFMA will be granted other powers essential for it to realize its responsibilities. First, it will have the authority to examine the following aspects of insured institutions: (i) the changes of the risk profile and other conditions of insured institutions, in order to make adjustments on applicable premium rates; (ii) the size, structure and integrity of the deposits of insured institutions, in order to decide if there are any problems with the assessment base of their premiums; and (iii) the integrity of the information reported by insured institutions.<sup>73</sup> The DIFMA should inform the CBRC if serious problems about insured institutions are detected. Second, the DIFMA can propose risk alerts to insured institutions if it finds capital inadequacy and other circumstances that adversely affect the safety of the deposit insurance fund or of insured deposits.<sup>74</sup> Third, when insured institutions' capital adequacy ratios are greatly reduced due to massive asset losses or other factors, under which the safety of the deposit insurance fund or the insured deposits are seriously compromised, the institutions should take timely measures to supplement their capital, control asset growth and massive transactions, and reduce leverage ratios.<sup>75</sup> The DIFMA can impose higher rates on institutions that fail to improve the situation.<sup>76</sup> Fourth, the DIFMA can require institutions to take corrective measures in a limited

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<sup>71</sup> *Id.*, at art. 3.

<sup>72</sup> *Id.*, at art. 7.

<sup>73</sup> *Id.*, at art. 13.

<sup>74</sup> *Id.*, at art. 15.

<sup>75</sup> *Id.*, at art. 16.

<sup>76</sup> *Id.*

time-frame if they: (i) do not pay adequate premiums; (ii) do not report information to the DIFMA or report mendacious information; (iii) reject or hinder the DIFMA's fulfillment of its mandates; or (iv) hinder the utilization of the DIF.<sup>77</sup> The DIFMA also has the authority to publicize the names of culpable institutions' directors and other directly responsible individuals.<sup>78</sup>

Surprisingly, although the Regulations touch on some of the main responsibilities of the DIFMA, they remain silent about the nature, legal form, structure, administration and personnel of this ambiguous yet fundamental new regulatory body. Currently, the PBOC (specifically the Financial Stability Bureau under the PBOC) is provisionally designated as the DIFMA by the State Council, and as such PBOC is primarily responsible for the management of the deposit insurance fund. As part of further implementation of the DIS, a new independent agency may be established in the future. Theories about the operation of the probable new agency vary. First, it could operate as a bureau under the CBRC so as to provide better and prompt protection to depositors; second, it could become an internal body under the PBOC, as the PBOC has been leading the legislative work of the DIS; or third, the DIFMA could be established outside of the PBOC and the CBRC to ensure that it has full competency and independence to fulfill its mandates.<sup>79</sup> Under the third speculated theory, the DIFMA will resemble China's National Council for Social Security Fund (NCSSF).<sup>80</sup> The DIFMA should be led directly by the State Council and should be able to operate independently without being subject to any external interference from the PBOC, the CBRC and other regulatory bodies, but instead should work cooperatively with them. The board of the DIFMA can be comprised of directors of each of the principal Chinese regulatory bodies. This design feature will create a counterbalanced atmosphere among different safety net participants. Although the appropriate form of the DIFMA is yet to be seen by the future implementation

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<sup>77</sup> *Id.*, at art. 21.

<sup>78</sup> *Id.*

<sup>79</sup> Jiye Hu, *Five Issues about Deposit Insurance*, 1 CHINA ECON. REP. 94, 94 (2015) [in Chinese].

<sup>80</sup> *See About the National Council for Social Security Fund*, CHINA NAT'L COUNCIL FOR SOCIAL SECURITY FUND, [http://www.ssf.gov.cn/Eng\\_Introduction/201206/t20120620\\_5603.html](http://www.ssf.gov.cn/Eng_Introduction/201206/t20120620_5603.html) (last visited July 23, 2015) (recounting that the Central Committee and the State Council agreed on August 1, 2000 to establish the National Social Security Fund (NSSF) and the NCSSF, an independent agency "to manage and operate" NSSF assets).

of the DIS, it is largely foreseeable that the introduction of the DIFMA will gradually incentivize China to conduct deeper reforms on the institutional design of banking regulation.

### **B. Mandatory Membership**

At least two questions arise concerning membership in the DIS, namely: (i) what types of financial institutions should be included?; and (ii) should membership be voluntary or compulsory?<sup>81</sup> “Fundamentally, all financial institutions that accept deposits from the public [] or might directly or indirectly represent a risk for the stability of the financial intermediation system should be included in the deposit insurance.”<sup>82</sup> Also, opinion is largely united today that membership for all financial intermediaries who meet the above criteria must be obligatory, as the *IADI Core Principles for Effective Deposit Insurance Systems* states, “Membership in a deposit insurance system should be compulsory for all banks.”<sup>83</sup> Voluntary membership will lead to adverse selection or increased moral hazard.

According to the Regulations, China makes the deposit insurance compulsory for all depository-taking institutions, including the state-controlled banks, joint-stock banks, and foreign lenders. Article 2 of the Regulations states that all commercial banks, rural cooperative banks, rural credit cooperatives and other depository institutions established in the territory of the People’s Republic of China should pay premiums and be incorporated into the deposit insurance scheme.<sup>84</sup> Notably, however, foreign banks’ branches in China and Chinese institutions’ overseas branches are not subject to the DIS, except in situations where China has established special arrangements with the requisite jurisdictions.<sup>85</sup>

One of the barriers to the establishment of the DIS in the past was the opposition from the Big-Five state-owned banks, which are the Big-Four Banks plus the Bank of Communications. As they had been granted implicit funding support, they would definitely be reluctant to participate in the DIS, as it would increase their costs. However, even though China’s banking industry has become

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<sup>81</sup> Bernet & Walter, *supra* note 5, at 30.

<sup>82</sup> *Id.*

<sup>83</sup> Int’l Ass’n of Deposit Insurers, *IADI Core Principles for Effective Deposit Insurance Systems*, Principle 7 (Nov. 2014), <http://www.iadi.org/docs/cprevised2014nov.pdf>.

<sup>84</sup> Regulations on Deposit Insurance, *supra* note 68, at art. 2.

<sup>85</sup> *Id.*

an increasingly less-concentrated market with the surge in the number of banks, the Big-Five Banks still have pivotal importance to the whole banking industry and account for an enormous market share in many aspects. For example, both shares of total assets and total liabilities of the Big-Five Banks exceeded 40% of shares of all commercial banks in the first quarter of 2014.<sup>86</sup> Therefore, if the Big-Five Banks were absent from the DIS, the effectiveness of the DIS would be seriously devalued.

As for the treatment of domestic branches of foreign banks and the foreign branches of domestic banks, some jurisdictions adopt “the principle of territoriality,” whereby only branches established in the home country would be insured, thus excluding foreign branches of domestic banks (Switzerland and Hong Kong are examples of this).<sup>87</sup> Other jurisdictions adopt “the principle of personality” and cover all domestic depository institutions whose parent institutions are established in the home country, and all of their domestic and overseas branches, but exclude local branches of foreign banks, as is the case of the United States.<sup>88</sup> There are also jurisdictions adopting both principles, such as Germany, France, and many other European Economic Area (EEA) member states.<sup>89</sup> According to the PBOC, China’s option largely reflects international common practice. While this design is reasonable, as China has just begun to implement its DIS, it may also be risky for foreign branches of Chinese banks that are incorporated in a host country adopting “the principle of personality,” meaning those branches would be not be covered by any deposit insurance scheme. This may bring instability to both China and relative host countries. Therefore, as China’s DIS matures, an extension of the membership to foreign branches of domestic banks will provide a higher level of protection. Conversely, to attract investment from foreign banks and improve the competitiveness of China’s banking industry, membership extension could also be given to domestic branches of foreign banks, so long as foreign authorities incorporate Chinese

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<sup>86</sup> CHINA BANKING REGULATORY COMM’N, TOTAL ASSETS & TOTAL LIABILITIES OF THE BANKING INSTITUTIONS AS OF Q1-2014, <http://www.cbrc.gov.cn/EngdocView.do?docID=97AFBD4530CE44B7B97D13CF74D58C04> (last visited July 20, 2015).

<sup>87</sup> See Fin. Stability Bd., *supra* note 66, at 48, table 5.

<sup>88</sup> See *id.* (It should be noted that the FDIC only covers deposits collected by the foreign branches of domestic banks if these deposits are designated as being “payable in the United States”).

<sup>89</sup> See *id.*

banks' overseas branches into their deposit insurance schemes accordingly.

### C. Limited but High-Level of Coverage

The core purpose of every DIS is to protect the interests of retail depositors and reduce the possibility of bank runs should a bank failure occur. Although a high-coverage level reduces the incentive for depositors to participate in a bank run, adequate compensatory controls are needed to ensure a proper balance between financial stability and market discipline. Therefore, most DISs in the world have adopted a limited scope of insurance coverage that covers the majority of depositors, but they have also left a substantial amount of deposits exposed to risks. However, as stipulated by contingent arrangements in response to the global financial crisis of 2007-08, many jurisdictions raised their insurance coverage limit, while many countries, e.g. France and Germany, also introduced a temporary blanket deposit guarantee.<sup>90</sup> In the aftermath of the crisis, these countries established credible plans to transition from the blanket guarantee back to the limited insurance coverage, but most jurisdictions had revised their schemes and remarkably raised coverage limits.

China will adopt a limited insurance coverage. The DIS will insure deposits of as much as 500,000 RMB (approximately \$80,000). In consultation with relevant departments of the State Council, the PBOC has the authority to adjust the coverage amount in line with economic development and changes of deposit structures and financial risks, and, accordingly, implement a new coverage amount upon the State Council's approval.<sup>91</sup> The Regulations adopt a "per depositor per bank" approach, which means the total amount of principal and interest of all insured accounts of a depositor in an insured institution will be fully reimbursed if they are within the range of the coverage limit. Any amount surpassing this ceiling will be exposed to the banks' solvency risk, but can also be reimbursed from the liquidating assets of the insured banks under bankruptcy proceedings. After reimbursing the depositors their insured, the DIFMA will be deemed as having obtained the creditor's rights with the same priority of the depositor against the insured institution within the scope of reimbursement.<sup>92</sup>

According to the PBOC's estimation based on data recorded through 2013,

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<sup>90</sup> *Id.* at 10-12.

<sup>91</sup> Regulations on Deposit Insurance, *supra* note 68, at art. 9.

<sup>92</sup> *Id.* at art. 5.

the insured amount proposed will be high enough to cover all bank deposits of 99.6% of depositors in China, meaning the majority of depositors will be fully protected.<sup>93</sup> This maximum protection amount is equal to 12 times GDP per capita, which is considerably higher than the schemes in other countries (2-5 times GDP per capita). Part of the reason is that Chinese depositors have a higher propensity to save. To a very large extent, deposits play the role that is provided by the social security system. The 500,000 RMB cap covers not only household depositors, but also corporate depositors, especially SMEs.

Besides the proportion of insured depositors, coverage of a DIS also includes the value of eligible deposits covered. Most DISs cover a broad variety of deposits, including secure demand deposits, fixed-term deposits and non-resident deposits. Some DISs also cover foreign currency deposits, deposits of nonfinancial companies, and public sector entities.<sup>94</sup> The Regulations do not clarify specific types of insured deposits, but states that all RMB deposits and foreign currency deposits of an insured institution will be protected.<sup>95</sup> Nonetheless, interbank deposits by other financial institutions, deposits by senior management to their own bank, and other uninsured deposits defined by the DIFMA are not covered by the DIS.<sup>96</sup> It could be reasonably speculated that Chinese DIS will provide protection to all RMB and foreign currency demand and fixed-term deposits and non-residents deposits, as compliant to international common practice. Interbank deposits and deposits of senior management in the same insured banks are excluded to reduce risks and moral hazard. Interbank activities largely incorporate shadow banking businesses, a significant factor contributing to the current fragility of China's financial system. Interbank activities contain high risks, investors in interbank deposits are normally institutions or individuals who have expertise coinciding with their ability to assume risks, and thus they are excluded by the DIS.

The proposed coverage limit could meet China's current need. It is wide enough to fully payout the majority of Chinese depositors; therefore, the transition from the implicit DIS to explicit DIS will have very limited influences

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<sup>93</sup> Instructions on China Deposit Insurance Regulations (promulgated by The People's Bank of China), at 4.

<sup>94</sup> Fin. Stability Bd., *supra* note 66, at 50, table 6.

<sup>95</sup> Regulations on Deposit Insurance, *supra* note 68, at art. 4.

<sup>96</sup> *Id.*



on retail depositors. As China is still under a stage of stable economic development, chances of bank insolvency are quite small. Even if banks encounter distress, regulators will have other techniques available to make sure depositors are immune to fluctuations. Even if serious risks are met, regulators could temporarily apply a blanket deposit scheme to protect depositors, just as they have been doing under the implicit DIS.

#### **D. Pricing Mechanism**

Sound funding arrangements are critical to the effectiveness of a DIS. Deposit insurers can choose either a flat-rate premium or a system that differentiates premiums on the basis of individual bank risk profiles. A flat-rate system is easier to be understood and administered but does not differentiate among banks with different risk exposures.<sup>97</sup> A risk-adjusted system may help to mitigate moral hazard by imposing differentiated rates on institutions appearing to have different risk profiles, but may also be more pro-cyclical.<sup>98</sup>

While most jurisdictions are still using flat rates, many countries have adopted risk-adjusted rates. From the founding of the FDIC in 1933 until 1991, all banks in the United States paid the same rate. The result was that better run banks subsidized those banks with a much higher risk profile. In 1991, the FDIC adopted a risk-based premium system.<sup>99</sup> The initial risk-based pricing system only relied on supervisory ratings and capital ratios. In 2006, restrictions on the FDIC's ability to assess premiums when the deposit insurance fund exceeded a certain level were eliminated, and differentiated methodologies were established for small banks (assets less than \$10 billion) and large banks (assets greater than \$10 billion). For smaller banks, a methodology using six financial ratios plus supervisory ratings was adopted and, with other minor modifications, this remains the basis of the small bank risk-based pricing system today.<sup>100</sup> For larger

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<sup>97</sup> See Int'l Ass'n of Deposit Insurers, *General Guidance for Developing Differential Premium Systems*, at 3 (Feb. 2005), [http://www.iadi.org/docs/IADI\\_Diff\\_prem\\_paper\\_Feb2005.pdf](http://www.iadi.org/docs/IADI_Diff_prem_paper_Feb2005.pdf).

<sup>98</sup> Bernet & Walter, *supra* note 5, at 38-41.

<sup>99</sup> See Federal Deposit Insurance Corporation Improvement Act of 1991 § 302 (amending 12 U.S.C.A. § 1817(b)(1)(A) (West, Westlaw through P.L. 114-114 (excluding 114-92, 114-94, 114-95 and 114-113) approved 12-28-2015)).

<sup>100</sup> The "Risk Measures Used to Determine Risk-Based Premium Rates for Banks with Assets Less than \$10 Billion . . . include: Tier 1 Leverage Ratio[,] Loans Past Due 30-89 Days / Gross Assets, Nonperforming Assets / Gross Assets[,] Net Loan Charge-Offs / Gross Assets[,] Net Income before Taxes / Risk Weighted Assets[,] Rapid Asset Growth Funded by Brokered Deposits[, and] Weighted Average Examination Component

banks, the FDIC initially adopted a system based upon capital levels, supervisory ratings and debt issuer ratings to reflect these views of relative risks.<sup>101</sup>

The financial crisis of 2007-08 proved the insufficiency of the above approach, as it failed to reflect increasing differences in risk profiles among big banks. Meanwhile, the emergency measures used to save big financial institutions during the crisis greatly reduced the amount of the deposit insurance fund, thus calling for modifications to reform the way the DIS was run. In this context, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was enacted in July 2010, which remarkably empowered the FDIC by giving it much greater discretion to manage the deposit insurance fund and reform the pricing mechanism of the American DIS.

A major reform of the *Dodd-Frank Act* with regard to the funding and pricing of the DIS was the Designated Reserve Ratio (DRR). The DRR refers to the balance of the Deposit Insurance Fund “divided by estimated insured deposits.”<sup>102</sup> From 2007 to 2010, before the *Dodd-Frank Act* was introduced, the DRR was fixed at 1.25%.<sup>103</sup> The *Dodd-Frank Act* raised the minimum DRR, which the FDIC is required to set each year, from 1.15% to 1.35%.<sup>104</sup> After the Dodd-Frank reform, the DRR was fixed at 2.00%, from 2011 to 2015.<sup>105</sup> Another major reform of the *Dodd-Frank Act* was the Assessment Base. Under the *Dodd-Frank Act*, the FDIC amended its regulations to redefine the base used for calculating deposit insurance assessments. Before the Dodd-Frank reform, the assessment base was the total domestic deposits of insured depository institutions since 1935.<sup>106</sup> Under the newly promulgated regulations, the assessment base of a depository institution must, with some possible exceptions, “equal the average consolidated total assets of [such] insured depository institution during the assessment period minus [its] average tangible equity . . . during the assessment

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Ratings”. Diane Ellis, *Deposit Insurance Funding: Assuring Confidence* chart 4 (Fed. Deposit Ins. Corp., Staff Paper, 2013), <https://www.fdic.gov/deposit/insurance/assuringconfidence.pdf>.

<sup>101</sup> *Id.* at chart 5.

<sup>102</sup> *The Deposit Insurance Fund*, FED. DEPOSIT INS. CORP., <https://www.fdic.gov/deposit/insurance/> (last visited July 22, 2015).

<sup>103</sup> *Id.*

<sup>104</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 332, 334, 124 Stat. 1376, 1539 (2010) (amended 12 U.S.C. § 1817(b)(3)(B)).

<sup>105</sup> 12 C.F.R. § 327.4(g) (2015).

<sup>106</sup> 2010 FDIC Q. 4, No. 4, at 15.

period.”<sup>107</sup> From then on, all depository institutions need to report their average consolidated total assets on a daily basis. The last major reform of the *Dodd-Frank Act* was the Assessment Rate. The changes to the assessment base made it necessary to change assessment rates. Most importantly, under the new risk-based premium rules implemented by the *Dodd-Frank Act*, there were adjustments to rates for types of funding that either posed heightened risk to the deposit insurance fund or that helped to offset risks to the deposit insurance fund.<sup>108</sup> In other words, institutions that pose higher risks to the deposit insurance fund—for example, by holding unsecured debt issued by another insured institution—must pay a higher rate.

In Europe, an analysis made in 2008 of the deposit insurance fund in 27 European Union (EU) member states showed that a risk-based premium system had only been introduced in 11 countries (i.e. Germany, France, Italy), and only seven of them were based on *ex ante* supply of a deposit insurance fund.<sup>109</sup> The reason why so few countries adopted risk-based premium rates, even though the positive effects of risk-based pricing mechanism are largely uncontested, can be traced back to the fact that the European Council Directive (EC) 94/19 on Deposit Guarantee Schemes (Directive 94/19/EC) had remained silent on this issue and left the design of pricing models to each member state. A new Directive 2009/14 explicitly recommends the introduction of risk-based premium models, but does not address specific aspects of the model to be applied.<sup>110</sup>

The United States took nearly 60 years to transition to a risk-based pricing mechanism. Many European countries started risk-based pricing model only recently, and most other countries in the world still have not incorporated risk-based approach into their DISs. This reflects some echoes that China should

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<sup>107</sup> 12 C.F.R. § 327.5(a) (2015).

<sup>108</sup> FDIC, Assessment, Large Bank Pricing, final rule, 32, at <https://www.fdic.gov/news/board/2011rule1.pdf>.

<sup>109</sup> Unit G09, Eur. Comm'n Directorate Gen. Joint Research Ctr., *Risk-Based Contributions in EU Deposit Guarantee Schemes: Current Practices*, at 9-10 (June 2008), [http://ec.europa.eu/internal\\_market/bank/docs/guarantee/risk-based-report\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/guarantee/risk-based-report_en.pdf).

<sup>110</sup> Directive 2009/14/EC, of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on Deposit-Guarantee Schemes as Regards the Coverage Level and the Payout Delay, 2009 O.J. (L 68/3). (On June 12, 2014, the European Deposit Guarantee Scheme Directive has been recast and it requires each EU member state to modify its savings protection schemes to meet the improved EU deposit protection rules. Most rules must be implemented by July 3, 2015 at the latest). See Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on Deposit Guarantee Schemes (Recast) (Text with EEA Relevance), 2014 O.J. (L 173/149).

not be overhasty to adopt a risk-based model, especially when the risk assessment system and supervisory rating system are both very immature. Therefore, the Regulations states that the premium rates are consisted of a benchmark rate and a risk-based rate.<sup>111</sup> At the initial stage, only the benchmark rate will be used, all institutions will be charged at an equal level. Later, when supporting regulations and techniques are being established, the risk-based rate will be effective and insured institutions will also be charged in a differentiated manner to reflect each institution's risk profile. Criteria for premium rates are decided and subject to adjustment by the DIFMA in line with changes of economic and financial development, deposit structure, and the accumulated adequacy of the deposit insurance fund, which will be implemented under approval of the State Council.<sup>112</sup>

The Governor of the PBOC, Zhou Xiaochuan, stated in a recent interview that the initial benchmark rates will be set between 0.01% and 0.02%, which is significantly lower than that of most countries, hence the reason that the likely impacts on insured institutions are deemed "very small." Premiums will not become a burden to insured institutions in the long run. On the contrary, they will benefit from the DIS inasmuch as the possibilities of bank runs will be greatly reduced. Nevertheless, the PBOC doesn't give a specific starting date or release any details about when and how to transition to the risk-based pricing mechanism. Based on the risk profiles of different types of depository institutions, big state-owned banks will likely enjoy lower rates than their smaller counterparts, because the latter often contain higher risk profiles and weaker capital conditions. In order to increase public confidence towards the newly launched DIS, and to offset the inequality among big and small institutions, more detailed regulations on the risk assessment methodologies should be devised, so as to make sure the insured institutions go through the transitional period smoothly.

#### **E. Reimbursing Depositors**

A well-designed DIS should reimburse depositors fully and promptly, with a clear and unequivocal trigger for depositor reimbursement. Regrettably, the Regulations only provide a very broad and general description about reimbursement without setting clear payout procedures and timelines. The

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<sup>111</sup> Regulations on Deposit Insurance, *supra* note 68, at art. 9.

<sup>112</sup> *Id.* at art. 10.

DIFMA is required to reimburse depositors in one of the following ways: (i) directly pay out depositors; (ii) order other eligible insured institutions to pay out depositors on behalf of the DIFMA; or (iii) provide guarantee, loss allocation or funding support to other eligible insured institutions, in order for them to buy or assume all or part of businesses, assets and liabilities of the institutions that are taken over, closed, or have filed for bankruptcy protection.<sup>113</sup> The DIFMA should follow the “minimum cost” principle when deciding specific ways to utilize the deposit insurance fund. The Regulations also make clear that, when one of the following conditions is met, depositors have the right to require the DIFMA to reimburse them where (i) the DIFMA is designated as the receiver of the insured institution; (ii) the DIFMA implements liquidation of the insured institution; (iii) the Court adjudicates to accept insured institution’s file for bankruptcy; or (iv) other situations approved by the State Council.<sup>114</sup>

To ease market panic driven by the failure of a bank, it is important that the DIS set in advance a clear process to promptly reimburse depositors. The design of the reimbursement process should at least cover the following basics: (i) reimbursement trigger; (ii) reimbursement period; and (iii) how and when the deposit insurer receives deposit information. As to the conditions that trigger a claim for reimbursement, international practice includes court-declared bankruptcy, the decision of the supervisory agency, or a combination of them.<sup>115</sup> The legally required timeframe to reimburse depositors ranges from “as soon as possible” as in the United States to a maximum allowed time.<sup>116</sup> EU member states are legally obliged to reimburse depositors within twenty business days (extendable to thirty business days by regulators or deposit insurers). As part of its effort to create a safer and sounder financial system and a uniformed banking union, the European Commission has proposed changes to existing European rules to further improve protection to depositors. One of the changes is easier and faster payouts, where repayment deadlines will be gradually reduced from the current twenty business days to seven business days in 2024.<sup>117</sup> Germany has

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<sup>113</sup> *Id.* at art. 18.

<sup>114</sup> *Id.* at art. 19.

<sup>115</sup> *Id.* at table 10.

<sup>116</sup> *Id.* at 23-24.

<sup>117</sup> Directive 2014/49/EU of the European Parliament and of the Council on deposit-guarantee schemes (recast)(text with EEA relevance) [2014] OJ L173/149, art. 8, at 14.

completed quick steps to follow this requirement by introducing a new deposit insurance law. Starting May 31, 2016, the maximum timeframe allowable for depositors to be paid out will drop from the current twenty business days to seven business days.<sup>118</sup> In jurisdictions where the deposit insurer is not legally obliged to reimburse depositors within a specific timeframe, such as in Australia and Brazil, the authorities have publicly committed to a timeframe that targets to demonstrate their commitment.<sup>119</sup>

As for the deposit information access, some deposit insurers receive information from supervisory authorities when they consider it necessary to trigger reimbursement.<sup>120</sup> As soon as the trigger is likely to take place, deposit insurers are expected to receive or request the information from insured institutions to prepare for the reimbursement. In other jurisdictions, such as the United States, information is received on a regular basis directly from member institutions and is used to construct a single customer view on an ongoing basis.<sup>121</sup>

Drawing lessons from international experience, further clarifications in China's DIS are expected to set up clear triggering conditions and timeframe to orderly and promptly reimburse depositors. As regards the information access, Article 10 of the Regulations articulates that insured institutions are required to report insured deposits, deposit structure and other information essential for calculating premium rates and paying out deposits on a regular basis, showing that China will adopt the United States mode with regard to deposit information access.

#### **F. Coordination with Other Financial Safety Net Players**

Coordination and cooperation with other elements of financial safety networking are important for maintaining an effective DIS. The experience of the recent financial crisis confirms that the safety-net participants, including prudential regulation, deposit insurance and the central bank, can inspire

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<sup>118</sup> On Nov. 19, 2014, the German Bundestag has adopted the Deposit Guarantee Scheme Implementation Act (Gesetz zur Umsetzung der europäischen Richtlinie über Einlagensicherungssysteme). Most rules of this regulation will enter into force on July 3, 2015. However, some elements will be effective earlier, on the day after its enactment. See <http://www.dw.de/germany-gets-new-deposit-insurance-law/a-18072954> (last visited Aug. 5, 2015).

<sup>119</sup> *Supra* note 68, at 23-24.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

confidence in market participants necessary to resist a crisis only by cooperating and making well founded joint decisions. It is essential to establish an institutionalized, formalized and permanent mechanism to improve information exchange among those safety-net participants.

The Regulations, though it does not touch the rationale of how the DIFMA will be located and organized, underscores the essential role that it would play in the safety net. It is required that the DIFMA participate in the Financial Regulation Coordination Mechanism (FRCM), and establish information sharing arrangements with the PBOC, the CBRC and other related regulatory bodies.<sup>122</sup> The DIFMA should be able to use the information-sharing techniques to obtain critical information of institutions' risk profiles, and to examine report and rating conditions. The DIFMA could also ask institutions to report other information if received information fail to meet their regulatory needs.

Despite this, the DIFMA also has the authority to suggest that the CBRC can take over, restructure, or close an insured institution if conditions formulated under article 38 and article 39 of the Law of Regulation of and Supervision on the Bank Industry are met, which are (i) where an institution is experiencing or is likely to experience a credit crisis, thereby seriously jeopardizing the lawful rights and interests of depositors; or (ii) where an institution operates in violation of laws or is not operated or managed properly, thereby seriously threatening financial order and undermining public interests.<sup>123</sup> Through this method, the DIFMA and the CBRC will be able to detect problems in banking sector before they pose serious risks to the overall financial system.

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<sup>122</sup> The FRCM was established in Aug. 2013, as a coordinating scheme among Chinese financial regulatory bodies to reinforce regulation in the financial sector. It resembles the Financial Stability Oversight Council of the United States established by the Dodd-Frank Act, who has broad authorities in risk identifying and monitoring, large financial conglomerates regulation and resolution and financial coordination. However, comparably, the FRCM is not a decision-making body but rather a coordinating platform for relevant regulatory bodies to share information and coordinate actions, without altering their existing regulatory functions. It is led by the PBOC and will involve chairmen of the CBRC, the CSRC (China Securities Regulatory Commission), CIRC (China Insurance Regulatory Commission) and SAFE (State Administration of Foreign Exchange). If necessary, the NDRC (National Development and Reform Commission), the country's top economic planner, and the MOF will also be invited to take part in the meetings. See Xiao Xu, *China State Council Launched New Financial Coordination Mechanism*, NAT. L. REV., available at <http://www.natlawreview.com/article/china-state-council-launched-new-financial-coordination-mechanism> (last visited Aug. 5, 2015).

<sup>123</sup> *Supra* note 68, art. 17.

#### IV. THE LIKELY IMPACTS OF CHINA'S DEPOSIT INSURANCE

The DIS is being introduced in China at a time when the economy and the financial market are less robust and there are greater risks accumulating in the financial industry. China's economy is poised for the weakest expansion since 1990s and policymakers have reduced the economic growth target.<sup>124</sup> The banking sector is about to experience a fundamental transition from a government-backed guarantee to a more modernized and liberalized developing mode. Absent a DIS, authorities will face difficulty in undertaking further reforms. Simply put, as a symbol of modern financial system, the DIS will significantly reshape China's banking regulation and risk resolution pattern, as well as accompanying other expected and unexpected consequences. Compared with the very widely accepted influences of the DIS in other jurisdictions, the introduction of the DIS in China may provide different echoes that adequately capture Chinese authorities' motivation for introducing such a scheme. This part will discuss the potential impacts of a DIS on the financial industry, the banking regulatory design and the depositors in China.

##### A. The Impact on the Financial Industry

Chinese authorities refrained from introducing deposit insurance in the earlier years of financial reform. But now they are proposing to face what must be considered a calculated risk in explicating the DIS in the presence of country-wide evidences that such a scheme sometimes fails to achieve expected containment of crisis frequency. Despite the many warning signs, it is likely that the establishment of the DIS will affect the following aspects of the financial industry.

##### 1. *Financial Stability*

A major argument in favor of deposit insurance is that it maintains and promotes financial stability by preventing inefficient bank runs arising from asymmetric information and self-fulfilling prophecies.<sup>125</sup> Depositors, retail depositors in particular, only have incomplete information about banks' financial conditions and hence may run on banks in anticipation of failures. Explicit deposit insurance effectively removes the depositors' haze in this respect. The

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<sup>124</sup> Neil Gough, *China Lowers Official Economic Growth Target*, N.Y. TIMES, at A1 (Mar. 4, 2015).

<sup>125</sup> See Douglas Diamond & Philip Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 403 (1983).



recent financial crisis revealed the importance of deposit insurance as a key element to ease depositors' anxiety. Some authorities increased the insurance coverage or even provided a blanket guarantee. These interventions came at a cost, but all in all prevented widespread bank runs from deteriorating the whole financial system. China will be no exception. Should an explicit DIS be in place, bank runs that occurred in HDB case or many other situations would become history forever.

Additionally, deposit insurance also enhances financial stability by co-constructing an effective market exit mechanism for banks. The deposit insurer is a key moderator in bank crisis management and resolution. Experience shows that liquidation can be a serious inferior way of handling bank failures.<sup>126</sup> This is because liquidation can entail a destruction of values, disruption to the provision of services, and other spillovers to the rest of the financial system. Some of that can be avoided if, instead, it is able to transfer the insured deposits and good assets to another well-functioning institution, which are the so-called assets taking-over through "bridge bank" mechanism.<sup>127</sup> Deposit insurance can effectively aide this strategy by injecting funding resources, up to but not beyond the expected amount to pay off insured depositors in liquidation. In this way, banks' critical financial services such as the payment and clearing systems will not be unnecessarily interrupted. In the case of a bank being taken over, being closed down or filing for bankruptcy, regulators have the first hand to utilize the deposit insurance fund to provide supports to other eligible institutions to take over the failing bank's good assets and businesses. Consequently, depositors' insured deposits will be transferred to a well-operating institution. In this way, deposit insurance will effectively promote banks' failure resolution.

However, it is important to note that deposit insurance is not a cure for financial crisis. The recurring financial turbulences that took place in the past decades demonstrate that the ability of deposit insurance to deliver favorable results in maintaining financial stability is very inadequate. Historic records show

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<sup>126</sup> The bankruptcy filing of Lehman Brothers led to some destructive outcomes that could have been avoided if a more effective rescue mechanism existed in 2008. *See generally* Federal Deposit Insurance Corporation, *The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, FDIC QUARTERLY, Vol. 5, No.2 (2011).

<sup>127</sup> The basic resolution strategy behind it is to break up a bank into a good and bad bit, and effect a sale of the economically critical parts.

that there are no necessary connections between the establishment of the DIS and the occurrence of banking crisis.<sup>128</sup> The DIS, when not properly designed, can even lead to financial turmoil in practice. Therefore, the significance of the DIS is not to eliminate possibilities of bank runs or insolvencies, but to, through early regulatory interventions, manifest the risks gathered in banking industry.

The establishment of the DIS will have great impacts on Chinese banks' internal governance and operating strategy will cause certain potential problems. Banks have to shift from traditional ways of deriving profits from the spread between deposits and loans, to a modernized multiple profit mode.<sup>129</sup> Moreover, the shadow-banking sector, which has long been considered as a major impetus for China's financial market and economy, will be excluded from the protection by the DIS. While this will help to strengthen market discipline, it also leaves room for future risks if a comprehensive framework for dealing with shadow banking crisis has not been established. All these considerations may add uncertainty to the function of China's DIS in maintaining financial stability.

All in all, the DIS is currently introduced in China simultaneously with interest rates liberalization, banking industry structural reform and many other tough reforms. International experience from the United States, Japan and Europe demonstrates that in this transitional period, greater vigilance should be given to the institutional design and phase-in implementation of the DIS. Chinese policymakers and regulators should intensify their supervision over the insured institutions as new reforms grant them expanded powers to chase rapid growth. Because China's financial system is so large and vulnerable, the costs could be very high if the gamble of introducing the DIS does not pay off.

## 2. *Moral Hazard Concerns*

Implementing deposit insurance is a tightrope act. On the one hand, an explicit DIS can significantly reduce the incidence of bank runs. On the other hand, an explicit DIS can fuel bank crises by giving banks incentives to take

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<sup>128</sup> Tianyong Guo & Shuangshuang Liu, *Deposit Insurance System is a Double-edged Sword*, 1 CHINA REP. 50, 51(2015).

<sup>129</sup> No doubt that deposit insurance will cause banks' funding costs to rise. In fact, Chinese banks already are battling with the potential for thinner profit margins after the PBOC cut interest rates in late Nov. 2014 for the first time since 2012. Because the central bank cut benchmark lending rates more than it cut rates on deposits, the difference between how much banks charge borrowers and how much they pay depositors could narrow sharply, pressuring profits.

unnecessary risks. The United States' experience in the 1980s and early 1990s suggests that any country that adopts an explicit deposit insurance must grapple with the destabilizing effects on the country's financial system.<sup>130</sup> This problem, known as "moral hazard," was perhaps the biggest concern driving many jurisdictions to adopt an explicit DIS.

Academia argues that deposit insurance can lead to moral hazard in at least two ways. First, under the government's guarantee, especially an explicit guarantee, the insured institutions would be willing to take more risks because they can capture profits while passing along losses to the government.<sup>131</sup> Second, the government cannot implement risk-preventing measures, because the insured institutions have no incentives to comply, knowing that the government will bail them out.<sup>132</sup> In addition, should a DIS be in place, depositors, creditors and shareholders do not suffer the full consequences of a institution's failure, and therefore, are less likely to monitor the institution's condition. As Professor William Lovett put it, "if governments and modern nations do not allow most banks to [fail], how can the leaders and managements of banking institutions be disciplined and avoid unduly risky, negligent, or adventurous lending policies (or simply poor asset-liability management)?"<sup>133</sup>

Far from being a mere theoretical concern, moral hazard in explicit deposit insurance is significant and quite real. Worldwide, explicit deposit insurance increases the likelihood of bank crises significantly. Combining deposit insurance with interest rate liberalization makes moral hazard even worse because it permits banks to chase high-yield investments carrying heightened risk.<sup>134</sup>

Despite the common view that explicit deposit insurance will contribute to moral hazard in banking industry, an explicit DIS may have the opposite effect in China by enhancing market discipline.<sup>135</sup> First, implicit DIS is *de facto* a

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<sup>130</sup> See Asli Demirgüç-Kunt & Edward J. Kane, *Deposit Insurance Around the Globe: Where Does It Work?*, 16 J. ECON. PERSP. 175, 176 (2002).

<sup>131</sup> See Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1130 (1999).

<sup>132</sup> *Id.*

<sup>133</sup> William A. Lovett, *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*, 49 OHIO ST. L.J. 1365, 1365 (1989).

<sup>134</sup> See Asli Demirgüç-Kunt & Enrica Detragiache, *Does Deposit Insurance Increase Banking System Stability?* IMF Working Paper 00/3 (Jan. 2000), 10-12, <https://www.imf.org/external/pubs/ft/wp/2000/wp0003.pdf>.

<sup>135</sup> Gang Zeng, *Differences Exist between China and Abroad: Deposit Insurance Should*

complete guarantee and therefore provides a higher level of protection than explicit DIS. By replacing the implicit DIS with an explicit one, Chinese policymakers shift from granting full guarantee to all banking accounts to a rather limited portion of accounts. The majority of depositors will still receive the same protection, where the wholesale depositors face uncertainty in being fully reimbursed and will definitely have more incentives to keep an eye on banks' ongoing operation. Second, from banks' perspective, they will be charged a certain amount of premiums to form a deposit insurance fund, which they are not obliged to under the implicit deposit insurance. Third, retail household depositors will start to discipline banks' behaviors, because the establishment of DIS fundamentally overturns their strong philosophy that all bank insolvencies will be backed up by the government. In short, China's explicit DIS will not make big movements in enhancing the safety and soundness of the banking system. Rather, the significance of China's DIS is to expose the risks in banking industry and encourage market participants to focus on the management of banks.

Therefore, China's financial market may not be poisoned by the moral hazard brought by the explicit DIS, as has happened in other jurisdictions. As the implementation of the DIS goes further and deeper, market participants will relax their vigilance and become reluctant to pay attention to the banks' operation. Therefore, future institutional design of China's DIS should make adjustments to the moral hazard concern as well.

### *3. Level Playing Field*

As previously analyzed, China's banking system is dominated by the state-owned banks. Since China has not established floating interest rates among its banks, it is of depositors' natural perception that the Big-Four banks enjoy an implicit guarantee from the government during financial distress and are therefore more trustworthy. As a result, compared with the developed financial market countries, China's banking system remains highly monopolistic with very few private small and medium-sized depository institutions.

The establishment of the explicit DIS may open the gate for the prolific development of small and medium-sized depository institutions, which are considered as the biggest beneficiaries supported by deposit insurance. As the private bank pilot program continues to expand, the number of small and

medium-sized private banks is likely to grow. Deposit insurance can to a large extent enhance the creditworthiness and competitiveness of small and medium-sized banks and create a level playing field. Moreover, deposit insurance provides small and medium-sized banks with a steady and robust market environment to operate their business through strengthening depositor confidence, as depositors will be equally reimbursed wherever they arrange their deposits. In the long run, deposit insurance will propel structural reform in China's banking industry and help form a more diversified banking sector. Chinese authorities may gradually retreat and leave the banks to bear their own risks, and depositors will be able to choose banks with greater safety and better services.

The proliferation of small and medium-sized depository institutions will ease the difficulties for SMEs in financing. Big state-owned lenders have long dominated China's banking sector and their needs are not appropriately in line with small and private enterprises, who thus suffer high financing costs. Specifically, when monetary tightening occurs, the first companies to experience funding difficulties are those with the most acute needs for funding, namely SMEs. Although China has been taking various steps to promote SME financing since around 2003, SMEs' funding difficulties have not been improved much.<sup>136</sup> The fundamental problem is that Chinese economy is dependent on indirect finance, particularly through those major state-owned banks. Banks have little incentives to lend to SMEs because they have hitherto been able to earn respectable net interest margins on loans to state-owned enterprises and local governments with little nonperformance risks.

The setup of the first batch of pilot private banks signifies the entry of private capital into the financial system, develops competitive market environment with co-existence of diversified ownership, and helps further formalize China's multiple-level banking system. Operational efficiency of banking sector will also be enhanced. Correlatively, with banks' net interest

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<sup>136</sup> Development of the non-state-owned sector of the economy was a key theme of the Third Plenary Session of the 16th Central Committee of the Communist Party of China in 2003. The Law on Promotion of Small and Medium-sized Enterprises was also promulgated in 2003. *See* Law on Promotion of Small and Medium-sized Enterprises, *available at* <http://www.smefair.org.cn/en/html/NEWS/Documents/article/1245129180205.html> (last visited Aug. 10, 2015).

margins expected to shrink in the wake of ongoing interest rate liberalization, and with the improvement of competitiveness of small and medium-sized banks, big banks are also in need of seeking new business strategies to keep gaining profits. In this sense, they may also gradually shift their focus toward lending to SMEs, especially if more and more large corporations start to borrow directly from capital markets and overseas.

Meanwhile, concerns are accumulated that deposit insurance may even deteriorate the playing field. The establishment of the DIS implies the increasing possibility of bank insolvencies, which may cause depositors unreasonably shift deposits toward big banks. Small and medium-sized banks will have more difficulties absorbing deposits. Furthermore, big banks are more robust and contain lower risks than their smaller competitors. When the risk-adjusted premium rates are implemented, small banks will face higher rates. Depositors may view it as higher risk, which will adversely affect the deposit raising capacity of small banks. Therefore, detailed legal procedures and preferential policies are needed to construct a favorable development environment for small and medium banks.

### **B. The Impact on the Banking Regulatory Structure**

With the establishment of the CBRC in 2003, China formed its contemporary banking regulatory structure. Before that, the PBOC had been operating as a versatile regulatory body. The PBOC not only implemented monetary policies and carried macroeconomic and financial responsibilities, but also supervised individual depository institutions. As the conflicts of the PBOC's roles as policymaker and as supervisor became increasingly evident, China decided to move the function of banking regulatory from the PBOC to the CBRC. The CBRC becomes the primary regulator of the Chinese banking sector and is responsible for both supervision and resolution of banks and other depository institutions. The PBOC only holds its authority in maintaining financial stability and conducting systemic risk control. In a case of bank run, the Financial Stability Bureau of the PBOC determines the issues of the liquidity support.

Since the new banking regulatory design took place, the divergence between the PBOC and the CBRC has become an issue hindering effective banking supervision, due to the regulatory overlap created through the unclear allocation of regulatory authority. The passage of the Regulations and the launch of the DIS

is a hard-fought “turf battle” between the PBOC and the CBRC. The fight between them for the dominating power in the design of the DIS is perhaps the most significant reason for the delay of launching such a scheme. To ease the tensions and accelerate reform, the State Council designated the PBOC as the directing authority for the DIS legislative work, and ordered the CBRC and other relevant authorities to effectively coordinate with the PBOC. Viewed from the quasi-intentional ambiguity made by the Regulations in defining the resolution powers of the DIFMA, however, the “turf battle” has not completely settled down.

The resolution powers of the DIFMA are tightly related to the overall design of the DIS, where the broader the mandates of the DIFMA are, the more operationally independent it can be in achieving regulatory goals without external interventions. Some jurisdictions consider the DIS as a mechanism merely to compensate depositors, while other countries, like the United States, adopts the DIS as a fundamental failure resolution mechanism to deal with bank insolvency.<sup>137</sup> Before the financial crisis, the function of the DIS varied significantly among jurisdictions. The crisis precipitated greater convergence in practices across countries and formed a consensus about the strong function that the DIS should play in financial regulation and risk resolution.<sup>138</sup> The Regulations do not explicitly express that the DIFMA will play the role of resolution authority, but from the diction of many articles and from the description of its responsibilities, it can be reasonably concluded that China’s DIS will not be a mere paybox, but

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<sup>137</sup> Under this context, the deposit insurer is at the meantime the resolution authority. Given the differences in financial safety net arrangements across jurisdictions, the mandates of a DIS can be broadly classified into one of the four categories: (i) “paybox” mandate that is only responsible for the reimbursement of deposits (e.g. Australia, Switzerland, Netherlands); (ii) “paybox plus” mandate where the deposit insurer has additional responsibilities such as intervening in insured institutions and arranging preventive or corrective measures to protect the covered deposits. (e.g. Brazil, U.K.); (iii) “loss minimizer” mandate where the insurer actively engages in the selection from a broader suite of appropriate least-cost resolution strategies. For example, the deposit insurer will help to sell an insured institution to a suitable partner, split up individual business areas, or prepare recapitalization in order to protect covered deposits. (e.g. Canada, France); (iv) “risk minimizer” mandate where the insurer has complete and comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities (e.g. U.S., Korea). *Supra* note 64, at 15-16. Some also categorizes the mandate of DIS as (i) pay box model; (ii) cost reducer model; (iii) resolution facilitator model; (iv) supervisor model, with progressively increasing resolution authority of DIS.

<sup>138</sup> *Supra* note 68, at 13-14.

will have broad responsibilities that the DIFMA needs to effectively participate in risk resolution of insured institutions.<sup>139</sup> The DIFMA, when established, will be granted sufficient powers to fulfill its mandates and will be able to intervene early into the insured institutions before they lose their going-concern values. Therefore, it's very likely that the DIFMA will gradually become another important pillar of the overall financial safety net and will work closely with the CBRC in the field of risk resolution.

The CBRC is currently leading the legislative work of more long-awaited banking infrastructural provisions--the Regulations on Commercial Bank Insolvency and Resolution (CBRC Regulations).<sup>140</sup> In line with international experience in dealing with the post-crisis era, the resolution power of the CBRC will likely be reinforced. It is conceivably true that the CBRC will have expanded authority and great power in providing insured institutions with a resolution mechanism, through assets transfer, liability restructuring, etc. Thus, the range of authorities of the DIFMA is greatly relevant to the CBRC under the context of failure resolution.

Temporarily, the introduction of the DIS will not change the institutional design of China's banking regulatory structure. The DIS will first operate as a fund, not as an independent regulatory agency. Yet, the regulatory expectations of the DIFMA can only be achieved when it could operate as an independent agency that is immune to the political control of other regulatory watchdogs. China's gradualist and unorthodox approach to the institutional reform in the financial sector augur the future possibility that the policymakers will make the DIFMA a Chinese FDIC. A fundamental reshuffle of China's banking regulatory structure will therefore likely to take place as the implementation of the DIS gets deeper.

### **C. The Impact on Depositors**

Like all DISs, the leading objective of China's DIS is to protect depositor's interests, which are reflected in following three aspects.

First, the publication of the Regulations is a clear announcement to the public that their deposits will be under explicit guarantee. A deposit insurance fund will

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<sup>139</sup> Evidences of this include: art. 7 of the Regulations states the DIFMA can take early corrective measures and risk resolution measures; art. 15-17 provide the DIFMA with authority to propose risk alerts, to urge insured institutions to take contingent actions and to advise the CBRC to impose relevant requirements, if institutions are confronted with capital inadequacy, serious credit crisis or violations of laws.

<sup>140</sup> *Supra* note 60.



be established as a credible source of funding to depositors. The sense of public assurance is important, because public concerns over the safety of deposits – whether based on facts or only rumors – can lead, and has led, to dangerous bank runs that can cause banks to fail. Consequently, concerns over one bank have, at times, led to concerns over others, resulting in the so-called contagion runs. Thus, public confidence promotes the stability of an individual bank.

Second, the DIS will strengthen market discipline over insured institutions and encourage them to promote sound and prudential management. Market discipline can happen in many forms, including private monitoring by interested stakeholders, corporate governance, and ousters of bank managers through the market for corporate control.<sup>141</sup> When the DIS is formally established, different institutions will have differentiated premium rates. As institutions with higher risks will be charged higher premiums, the DIS can actually improve the banks' internal control. Meanwhile, the DIFMA has broad regulatory and resolution authority to actively intervene in institutions' daily operations and take corrective measures in a timely manner, which then enhances the stability of banking industry and reduces institutions' possibility to fail.

Third, the incorporation of the DIS is a fundamental improvement of China's financial safety net. With an appropriate financial safety net in place, depositor confidence tends to be greater and the onset of financial crises less likely than otherwise. Altogether with the PBOC as the lender of the last resort, and the CBRC as the prudential regulator, the DIFMA, when established and independently operated, will become another peak of China's financial regulatory framework. Thus, a more comprehensive safety net will further assure depositor protection.

The PBOC states that the launch of the DIS will largely protect depositors' interests. However, rather than strengthening depositor confidence, there is a chance that the establishment of the DIS will bring more panic to China's financial market. The DIS will obliterate the depositors' presumption that their deposits will be guaranteed by the government. Therefore, a bigger challenge may appear at an early phase of the implementation of China's DIS: to wean the

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<sup>141</sup> Patricia McCoy, *The Moral Hazard Implications of Deposit Insurance: Theory and Evidence* at 20, presented at Seminar on Current Developments in Monetary and Financial Law (Oct. 23-27, 2006).

public from its deep-rooted attachment to the implicit government-backed DIS without sparking a panicked shift of capital from small and medium banks to large banks.

In order to eliminate depositors' incomprehension and misunderstanding about the DIS, Chinese authorities shall advance the public awareness in the DIS. "The general public need to know about the deposit insurance system, understand it, and be able to rely on rapid payout by the Deposit Insurer in the event of a bank's failure."<sup>142</sup> In order to achieve the smooth implication of the DIS, the PBOC should not only further refine and detail the future DIS regulations by fully taking into account public opinions, but also use a variety of communication tools to deepen depositors' understanding of the DIS on an ongoing basis.

In sum, besides the above-mentioned trade-offs, the DIS will help reduce the perception that there is no risk in China's banking industry, and will pave the way toward interest rate liberalization and a diversified and balanced banking sector. Without such insurance, depositors could suffer great losses if banks sharply raise rates to attract savers but then have trouble making the big payouts. The DIS frees up banks to compete for depositors' money without risking the savings of their customers, which potentially challenges China's biggest banks for deposits and introduces some more market-based principles into the banking system. Moreover, the DIS will generate a capital flow from banks to non-bank financial institutions, i.e. securities institutions, insurance companies and derivatives markets, as wholesale account holders will utilize more deposits to invest in stocks, trusts and other financial products. It is a great opportunity for banks to improve product design, marketing strategy and risk control, in order to capture more customer resources. From this perspective, the DIS will also strengthen China's financial innovation and capital market development.

### CONCLUSION

The establishment of the DIS is a major step towards reinvigorating China's increasingly lumbering financial system and a long-awaited move aiming at

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<sup>142</sup> Paul Tucker, *The Role of Deposit Insurance in Building a Safer Financial System*, speech at the IADI Annual Conference (Oct. 25, 2012), at 1, <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech614.pdf>.

propelling further financial reforms. The proposed DIS can be characterized as (i) compulsory insurance; (ii) limited but comparably high insurance coverage; (iii) risk-adjusted pricing mechanism; and (iv) favorably strong regulatory and resolution features. Although the Regulations outline the fundamentals of China's deposit insurance, its incompleteness and ambiguity also leave many important issues blank, requiring further clarifications and the promulgation of concomitant regulations.

There are several regulatory lessons of the DIS. First, deposit insurance has a powerful ability to reinforce public confidence and financial stability during financial distress. The introduction of the DIS in China is not an option but a must made necessary by the painful bailout history and the urgent status quo. Second, deposit insurance is not an omnipotent cure that can eliminate all banking crisis. It adds another important layer to China's financial safety net. Third, the design of the DIS should be equal and transparent among all market participants, especially when it comes to the setting of premium rates and other issues that may differentiate the treatment of different depository institutions. Fourth, the establishment and implementation of the DIS should follow a phased-in step, in line with the conduct of other relevant financial reforms, and fully take into account China's ability to push forward all these reforms simultaneously. Fifth, Chinese banks are facing a real challenge of the need to achieve improved governance. Banks should take pre-event countermeasures in terms of information disclosure, regulatory reporting, compliance mechanism, and etc. Sixth, Chinese policymakers and regulators need to enhance cooperation among different regulatory agencies and continue to push forward reform on the institutional design of financial system. Last, public awareness and comprehension towards the DIS should be improved through various channels to create a favorable environment for the sound development of the DIS and other financial schemes.

Along the road towards future reform, China will encounter multiple tough balances to strike. It's foreseeable that in the near term, deposit insurance will evoke strong skepticism in the market. What's at stake is that despite those enormous trade-offs, policymakers and regulators should give up their regulatory inertia to bailout-troubled institutions, and implement the DIS in a true sense. Short-term fluctuations are temporary costs to pay, and the real effectiveness of

the DIS will be verified by practice.