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The Supervision of Financial Conglomerates in China in the Post WTO Era—The Challenges of Risk Concentration and Risk Contagion

Kuan-Chun Chang

I. Introduction

China's recent entry into the World Trade Organization (WTO) has presented significant challenges for the Chinese government in regulating financial conglomerates. Since the General Agreement on Trade in Services (GATS) requires the liberalization of financial services and market access for WTO signatory firms, China must open up its financial markets within the five-year transitional period. Experts predict that approximately $56 billion a year will be pumped into the economies of China and its major trading partners. However, one question remains with respect to China's financial regulatory and supervisory system: Will it provide a safe and non-discriminatory investment environment for foreign financial institutions? Perhaps not. Due to the ongoing consolidation of financial institutions, the Chinese government is expected to deregulate current restrictions that may impede the integration of the financial service industry and to create laws, such as the Financial Holding Company Act in order to promote competition.

By the time the market opens, Chinese financial institutions must be competitive with foreign ones. One tool in achieving this goal is to establish a financial holding company system that enables affiliates of the holding firms to exchange client information, cross-market one another's products, share facilities, and, ultimately, benefit economically and productively. Thus, laws and regulations regarding the licensing, inspection and other supervisory affairs of financial conglomerates are supported by domestic financial service businesses.

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1 S.J.D. candidate, Georgetown University Law Center; LL.B., National Chengchi University, Taiwan (1997); M.B.A., National Chengchi University, Taiwan (2000); LL.M., University of Pennsylvania (2001); LL.M. in Banking and Financial Law, Boston University (2002).


3 Tatiana Boncompagni, Eastward ho! Entry into the WTO Was Just the Beginning, Greet a New $56 Billion Trade Marketplace, LEGAL TIMES, Jan. 7, 2002.

Financial conglomerates have posed many supervisory problems for regulators, including group-wide capital adequacy, double or multiple gearing, intra-group transaction and exposure, and risk contagion. Financially developed countries as well as relevant international organizations have noted these issues and made substantial efforts to address them.\(^5\) However, since the development of financial conglomerates in the Great China Area is still in its early stages, these supervisory issues and problems could easily be neglected. In the WTO era, the boom of financial conglomerates is just a matter of time. Thus, it makes sense to identify and address potential problems in advance. The risk concentration and contagion problem occurring in a financial conglomerate can cause adverse effects on the safety and soundness of entities of the conglomerate and even lead to systematic risk. Thus, this article will focus on this most important issue. Part II will discuss how the financial service industry developed in China in the WTO era and will review the necessity of permitting the formation of financial conglomerates. Part III will focus on how risk concentration and contagion problems occur and their effects. Part IV explains the types of regulatory and supervisory tools that are provided by the United States and other international organizations to cope with this problem and their effectiveness. In Part V, I discuss the defects of the current system of the supervision of financial conglomerates in China and suggest reforms to the current supervision system to tackle the risk concentration and contagion problem in the Great China Area in accordance with international standards while meeting the challenges posed by the WTO era.

II. **Overview of Financial Conglomerates**

A. **Financial Conglomerates — Definition, Structure, Advantages, and Disadvantages**

1. **Definition of Financial Conglomerates**

   No existing statutory laws have specifically defined "financial conglomerates." In the United States, the term "financial conglomerate" refers to a "financial holding company and its subsidiaries" or a "bank

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\(^5\) For example, the Joint Forum of Financial Conglomerates, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissioners (IOSCO), the OECD and the G-10.
and its financial subsidiaries. In Germany, on the other hand, credit institutions themselves can engage in the business of investment funds and securities underwriting. Financial holding companies are also a permitted form of financial conglomerate. It its 1995 report, the Tripartite Group of Bank, Securities and Insurance Regulators defined “financial conglomerates” as follows:

[A]ny group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance). Such an entity is likely to combine businesses which are subject to different schemes of supervision and might also include financial activities which, in many countries, are not conducted in an entity which is subject to solo prudential supervision.

According to this definition, a “financial conglomerate,” includes at least the following characteristics:

1. It relates to a group of enterprises,
2. It is formed by different types of financial institutions, and
3. The difference between firms involved is often related to the difference in their supervisory rules.

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7 Gesetz über das Kreditwesen [German Banking Act] §1 Nr. 3(a) BGR, available at http://www.bundesbank.de/bank/download/pdf/kwg_e.pdf.

8 Tripartite Group on Banking, Securities and Insurance Regulators was initiated by the Basel Committee on Banking Supervision in 1993. Its main duty is to address a range of issues relating to the supervision of financial conglomerates. This duty was taken over by the Joint Forum of Financial Conglomerates, which was established by the Basel Committee, the International Organizations of Securities Commissioners (IOSCO) and International Association of Insurance Supervisors (IAIS) in 1995.


2. The Structure of Financial Conglomerates

Three types of financial conglomerates currently exist: (1) the “complete integration” model, (2) the “bank parent, nonbank subsidiary” model, and (3) the “financial holding company” (or “FHC”) model. Each model has its advantages and disadvantages:

a. The Complete Integration Model

Compared to other models, the complete integration model is the most advantageous. Resources can be shared among the various departments engaged in different businesses. This will enable managers to produce mixed outputs at the lowest theoretical cost. However, many problems belie the complete integration model, including anti-competitive behavior, risk concentration and contagion, and conflicts of interests. These problems are greatest under the full integration model. Furthermore, this model cannot be supervised by a single regulator. On the other hand, it is also difficult for several functional regulators to supervise because it is impossible to segregate products and services.

b. The Bank Parent, Nonbank Subsidiary Model

The Bank Parent, Nonbank Subsidiary model was adopted by the Gramm-Leach-Bliley Act. This model has two major attributes (1) strengthening banks by paying them fee incomes with extra dividends, and (2) under the principle of corporate separateness, the parent bank bears only limited liability of financial subsidiaries so that safety and soundness can be maintained. There are three main disadvantages to this model: (1) the profitability of the bank may be adversely affected by the collapse of the subsidiary; (2) the bank’s reputation as well as the

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11 The “full integration” model is also recognized as “universal bank” which permits all financial activities be conducted within a single corporate entity. See Richard J. Herring and Anthony M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 J. Fin. Services Res. 4, 213, 223 (1990).

12 This model is a structure in which the banking function is conducted in the corporate parent and non-bank functions are conducted in separately incorporated subsidiaries of the parent bank. See id. at 225.

13 This structure requires banks to conduct non-banking activities through a holding company. See Herring and Santomero, *supra* note 10, at 226.


costs of funds may be adversely affected by the failure of any of its subsidiaries; and (3) if the government safety net is extended to financial subsidiaries, the problem of excessive risk taking caused by moral hazard will be exacerbated.

c. The Financial Holding Company
The financial holding company is another model permitted by Gramm-Leach-Bliley Act. Three advantages of this model are: (1) the legal separateness simplifies regulation and supervision of the banking activities of the conglomerate and facilitates functional regulation of its nonbanking activities; (2) the safety and soundness of the bank can be isolated from the performance of the nonbank affiliates because the holding company plays a role as a cushion between them; and (3) it provides protection to the government with respect to the government’s deposit insurance funds by limiting the additional risks permitted to insured depository institutions. But of all the models, the financial holding company model is perhaps the most inefficient one. The high costs of maintaining a holding company are likely to offset the benefits it generates from the economy of scale and economy of scope. Also, the holding company system makes the corporate structure of financial conglomerates more complex, which makes it easier to avoid affiliate transactions.

This article will analyze these three models from the perspective of risk management and cost-benefit analysis and try to reach a conclusion as to which model might best effectively manage the risk concentration and risk contagion at the lowest costs.

B. Advantages and Disadvantages of Financial Conglomerates
Whether or not to permit the formation of financial conglomerates is a highly disputed issue. Financial conglomerates are formed because financial firms may achieve synergies or economies of scope that will make it more profitable to provide a range of services within an integrated corporate group rather than each service through a separately managed corporation. In addition, financial conglomerates

17 Herring & Santomero, supra note 11, at 225.
18 Wagner, supra note 16, at 394.
19 See 12 U.S.C §1843 (k)(1).
20 Herring & Santomero, supra note 11, at 25.
21 Wagner, supra note 16, at 391.
22 This issue will be addressed later in this article.
23 Herring & Santomero, supra note 11, at 6.
may also enjoy a dynamic advantage, because conglomerates have more scope to develop innovative new products and services in response to changing technology and market conditions, so they may be better able to respond to consumers’ needs. However, opponents point out that by controlling the full range of substitutes for a financial product, financial conglomerates may be able to acquire and exercise monopoly power to raise prices above marginal costs. Also, financial conglomerates will have limited entry and will be able to enforce mandatory joint-product sales.24 One point to analyze concerning this issue is whether products provided by different financial firms are substitutable. If these products are similar and substitutable, allowing the formation of financial conglomerates may raise the anti-competition problem. Conversely, if these products are distinct in nature, the monopoly concern may be unnecessary. Views on this “substitution” issue are inconsistent.25 In fact, the function and business of banks is unique. A bank’s checking account differs from a Money Market Mutual Fund (MMF), because an MMF assumes that all depositors will want their funds simultaneously. A bank, on the other hand, uses statistical methods, to predict what a depositor’s demand for liquidity will be with great accuracy. This ability allows banks to invest the portion of a depositor’s money not needed for a depositor’s short-term liquidity in illiquid assets that offer higher rates of return.26 Furthermore, the banking business differs from insurance because the payment of insurance funds depends on the occurrence of uncertain events. However, a bank checking account is ready for withdrawal at any time. Therefore, the segregation between the commercial banking market, the insurance market, and the investment banking market exists so that monopoly will not occur, even though financial conglomerates do have some competitive advantages.

III. How the Problems of Risk Concentration and Risk Contagion Occur and Their Adverse Effects

A. Risk Concentration Issues

Risk concentration may occur at the group level when different entities within the conglomerate are exposed to the same or similar risk

24 Id. at 12.


26 See Macey, supra note 25, at 701.
factors or to apparently unrelated risk factors that may interact under stressful circumstances.27 Because risk concentration can occur in a financial conglomerate's assets, liabilities, or off-balance sheet items through the execution or processing of transactions or through a combination of exposures across these broad categories, failure to manage it can lead to systematic risk. Thus the significant issues become how to ensure that conglomerates have adequate risk management process in place to manage group-wide risk concentrations, how to create a system to monitor material risk concentration on a timely basis, and how to control the risk concentration directly by statutory laws and regulations. It is extremely important to set up a mechanism enabling supervisors to deal with material risk concentration.

A few current laws and regulations do handle some of the above issues. For example, sections 23A and 23B of the Federal Reserve Act in the United States, establish both quality and quantity restrictions on affiliate lending.28 Similar legislation exists within the European Union.29 The question remains whether methods provided by these laws are perfect or whether there are still some loopholes. This question will be answered later in this article.

B. Risk Contagion Issues
Risk contagion is probably the most significant problem associated with the formation of a financial conglomerate. It refers to the risk suffered by a conglomerate's individual entity and its adverse impact on the financial stability of the entire group or on the markets in which the constituent parts operate.30 Risk contagion can occur due to a direct financial connection between a problematic entity and a healthy one. Even in the absence of a direct financial connections, risk contagion can also be reflected by reduced public confidence in the stability of individual entities or the conglomerate as a whole because the public tends to view financial conglomerates as a single economic unit.31 Reduced confidence in either leaves regulators a new problem to tackle.

28 For details, see 12 U.S.C. §§ 371(c) and 371(c)(1).
30 Supra note 8, at 18.
31 Berghe & Verweire, supra note 10, at 161. See also Koguchi, supra note 14, at 31.
At least three issues derive from this problem: (1) how to erect a firewall between different entities of a financial conglomerate so as to limit the financial connections and prevent financial difficulties occurring in one entity from adversely affecting another; (2) how to enhance the market discipline to encourage public disclosure for the purpose of strengthening the public confidence; and (3) how to determine the extent to which the official safety net needs to be extended to address the financial problems of financial conglomerates encompassing banking sectors.

C. The Nature of China's Financial Markets and Regulation After China's WTO Accession

1. China's WTO Commitment Regarding Financial Services

According to the bilateral agreement signed by the Peoples' Republic of China ("PRC") and the U.S. in November 1999, China has agreed to the following market changes for financial service businesses:

(1) Banking: Two years after the PRC enters the WTO, foreign banks may conduct local currency business (i.e., deposit taking and lending) with Chinese enterprises in specified geographical regions. In other words, for two years after accession, foreign banks will receive qualified national treatment within specified regions. Five years after the accession, the PRC will lift customer and geographic restrictions, and foreign banks will be able to conduct retail business, principally taking deposits from, and making loans to Chinese individuals in local currency. Foreign banks also will be able to establish branches anywhere in the PRC.

(2) Securities underwriting: The PRC agreed to permit foreign brokerage firms to operate in the PRC, subject to fairly tight restrictions. Foreign firms who want to invest in Chinese securities underwriting companies would have use joint ventures ("JV's") and the foreign stake would be limited to thirty-three percent. The JV's would receive national treatment in order to underwrite domestic equity offerings. In addition, they could underwrite and trade in international equity and all corporate and government debt issues. Even more significantly, the PRC pledged a concomitant expansion in the permissible scope for foreign joint venture securities companies as the scope of business activities of Chinese securities firms grows.

(3) Fund management: The PRC agreed to permit foreign fund managers to operate in China, also subject to fairly tight restrictions. Foreign investment in JV fund management companies will be limited to
thirty-three percent upon the PRC's accession. Three years following accession, the limit will rise to forty-nine percent. Thus, over time, foreign financial firms will receive national treatment and experience an expansion in the scope of business concomitant with Chinese firms.

(4) Insurance services: The PRC agreed to award licenses to foreign insurance companies to do business in the PRC solely on the basis of prudential criteria. The PRC pledged to abandon economic needs tests (i.e., conditioning the grant of a license on the economic needs of the locality in which the foreign firm proposes to do business) and to eliminate quantitative restrictions on the number of licenses it issued. With respect to FDI in specific insurance activities, the PRC agreed to grant foreign insurers the right - effective immediately upon WTO accession - to take up to a fifty percent equity stake in local life insurance companies, up to a fifty-one percent stake in non-life insurance companies, and up to 100 percent in re-insurance companies. These JV's are now empowered to insure large-scale risks, and foreign life insurance firms may pick their own JV partners. However, their operations would be restricted to a dozen key Chinese cities, including Shanghai and Guangzhous, that the United States has interest in relations with during the first two-to-three years following accession. Two years after accession, the PRC pledged it would open up twelve more cities, including Beijing, and permit foreign non-life and re-insurance companies to form wholly owned subsidiaries. Five years after accession, the PRC would drop all geographic restrictions on licensing, and permit nation-wide branching. Regarding the scope of activities, the PRC agreed to allow foreign property and casualty firms to insure large-scale commercial risks nation-wide immediately upon accession. During a five-year phase-in period, the PRC promised to expand the scope of permissible activities of foreign insurance companies to include group, health, and pension products. Whether foreign insurers could offer group plans to companies that are not based in the same city as the insurer and whether these insurers could open branch offices is still unclear. Significantly, the PRC made no commitments on market access for foreign insurance brokers.

In this agreement, China still makes no provision for the entry of foreign financial conglomerates because the formation of financial conglomerates is currently prohibited in China. Put another way, the relic of protectionism can still be seen in this agreement. Thus, in the discussion that follows I will examine whether the extent of market

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32 Non-life insurance products include health, pension, and property policies.
liberalization needs to be raised and whether to permit the formation of domestic and foreign financial conglomerates.


Although China’s inclusion in the WTO has required it to open its financial sector to foreign competition over the next five years, viewpoints on whether to liberalize its domestic financial service market vary.

Advocates of opening up the market assert that despite some competitive advantages of foreign institutions, their presence will be beneficial as new products as well as new management and marketing techniques will be introduced into China, accelerating its domestic growth. Moreover, to strengthen the competitiveness of domestic financial institutions, it is also necessary to permit the affiliation between commercial and securities firms and/or insurance companies. Further, it would be especially helpful to allow the joint venture between domestic financial institutions and foreign financial institutions. Also, opening the competition to foreign financial conglomerates may encourage reform of the current financial regulatory and supervisory system to meet international standards.33

On the other hand, some contend that control and monitoring of foreign financial institutions must be enhanced because such institutions may engage in regulatory arbitrage, unfair competition, or the poaching of human resources from domestic financial institutions, which impedes the development of domestic financial industries.34

Competition, including competition from international sources, forces companies to reduce waste, improve management, and become more efficient. High cost activities, intended to gain or maintain preferential credit access or other privileges, are also less feasible in liberalized environments.35 Thus, changes brought about by market

liberalization can reduce the operational costs of providing financial services. Competition then forces institutions to pass on cost-savings to consumers, and the spread between lending and deposit rate decreases, as do commissions and insurance premiums. Open and more efficient financial markets affect savings and investment, and improve the inter-temporal allocation of resources. Competition among financial institutions, the liberalization of interest rates, and the emergence of new savings instruments are likely to increase the returns to investments. This increase stimulates aggregate savings and higher investments that, in turn, boost growth. As mentioned above, after its WTO accession, China has become the biggest capital “vacuum” in the world. However, without market liberalization the Chinese financial industry’s capability to maximize huge capital and make it more circulative is doubtful. Thus, protectionism not only mitigates the entry of foreign capital but it also impedes the growth of the Chinese economy.

The most important concern of the Chinese government is perhaps that foreign financial institutions will end up dominating the domestic market after liberalization and will abuse this position. However, if a government wishes to maintain a certain national presence in the domestic market, or wishes to provide temporary support to national suppliers, then from an efficiency perspective, these objectives are better attained through fiscal incentive rather than through restrictions on trade. The provision of such incentives will not be difficult to accomplish because most Chinese commercial banks are state-owned.

From the preceding paragraphs, it can be concluded that broadly opening the financial market is essential for both the economic growth and the expansion of the domestic financial service industry in China. If market liberalization is inevitable and beneficial, then effective financial regulations will be the key to making the open-up even more successful. Thus, the next part of this comment will review the American financial regulations that address risk concentration and contagion, and then examine the current supervisory system in China.

IV. Tools Used to Supervise Risk Concentration and Risk Contagion in the United States, and Other International Standards

Before the promulgation of the Gramm-Leach-Bliley Act (GLBA) in the United States, there were no laws or regulations designed particularly for the supervision of financial conglomerates because

36 Id. at 21.
securities firms and insurance companies were not permitted to affiliate with banks. However, some laws and regulations promulgated before the GLBA — for example, Section 23A and 23B of the Federal Reserve Act and the Glass-Steagall Act — were often referred to as the “Chinese Wall” because they prevented the risk concentration and risk contagion problems. The GLBA grants the Federal Reserve Board the plenary authority of “umbrella supervision,” as opposed to other regulators, including securities regulators and state insurance regulators, who are granted their authority on the basis of the nature of the activity they perform. Laws and regulations prior to the GLBA and regulatory changes in GLBA will be addressed in the following paragraphs.

The Tripartite Group of Bank, Securities and Insurance Regulators and the Joint Forum of Financial Conglomerates were formed to address a range of issues relating to the supervision of financial conglomerates. Their findings have been published in many reports. Although guidelines provided in these reports are unenforceable by regulators, the guidelines, like the work of the Basel Capital Accord, are important reference materials for regulators and legislators.

A. Tools Provided by the United States

1. Sections 23A and 23B of the Federal Reserve Act

Sections 23A and 23B of the Federal Reserve Act are known as quantitative and qualitative restrictions on banks’ transactions with affiliates.\(^{37}\) To prevent banks from taking excessive risks from a single affiliate, and thus create risk concentration and risk contagion, Section 23 provides:

A member bank and its subsidiaries may engage in a covered transaction\(^{38}\) with an affiliate only if (A) in the case of any affiliate, the


\(^{38}\) “Covered Transaction” is defined as a transaction with “an affiliate of a member bank [including]—

(A) a loan or extension of credit to the affiliate;
(B) a purchase of or an investment in securities issued by the affiliate;
(C) a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;
(D) the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or
aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and (B) in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank.  

Given that banks may cause risk contagion by attempting to benefit their affiliates or help their affiliates improve difficult conditions through purchasing low quality assets from their affiliates, 23A also prohibits member banks and their subsidiaries from purchasing "a low-quality asset" from an affiliate unless the bank or such subsidiary, pursuant to an independent credit evaluation, committed itself to purchase such asset prior to the time such asset was acquired by the affiliate." Because of the dynamic nature of financial markets, the types of affiliate transaction vary from time to time. While it is seldom possible to modify the scope of "covered transactions," the Federal Reserve Board tends to make the new types of transaction fit into the enumerated "covered transactions" through interpretation. For example, checking accounts of parent or non-bank subsidiaries at subsidiary banks present the probability for overdrafts and so should be regarded as "extension of credit" to an affiliate by the subsidiary bank.  

Moreover, Section 23B of the Federal Reserve Act provides that banks can only deal with their affiliate at arm's length. This section

(E) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate. See 12 U.S.C. §371c(b)(7).


40 The term "low quality asset" means an asset that falls into any one or more of the following categories: (A) an asset classified as "substandard," "doubtful," or "loss," or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency; (B) an asset in a non-accrual status; (C) an asset on which principal or interest payments are more than thirty days past due; or (D) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor. See 12 U.S.C. §371c(b)(A)-(D).


43 Sec. 23 B (a)(1) provides that a member bank and its subsidiaries may engage in any of the transactions described in paragraph (2), only — (A) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (B) in the absence of comparable transactions, on terms and
may effectively prevent a bank from assisting its affiliate to solve liquidity problems without considering the benefit to itself and the interest of its customers. Otherwise, losses may occur and risks will be transferred from the affiliate to the bank. If non-arms-length transactions are made too often, banks may take on excessive risks and so cause risk concentration.

Since GLBA was passed, financial subsidiaries of banks have been permitted to engage in broad types of financial businesses, with the exception of insurance underwriting. To make 23A and 23B more effective in meeting the supervisory needs arising from this change, a financial subsidiary of a bank is deemed to be an affiliate of the bank. Also, to prevent evasions of the Federal Reserve Act and the Gramm-Leach-Bliley Act,

any purchase of, or investment in, the securities of a financial subsidiary of a bank by an affiliate of the bank shall be considered to be a purchase of or investment in such securities by the bank; and any extension of credit by an affiliate of a bank to a financial subsidiary of the bank shall be considered to be an extension of credit by the bank to the financial subsidiary if the Board determines that such treatment is necessary or appropriate.

When inspecting an affiliate transaction in the holding company system, the Federal Reserve Board requires a list of subsidiary bank transactions with affiliates and reviews the holding company’s policies and procedures regarding intercompany transactions of subsidiary banks. If the bank’s condition is weakened due to the extension of credit to or the nature of transaction with the affiliate, special attention will be given.

While Section 23A and 23B have successfully reduced the possibility of risk concentration and risk contagion within a financial conglomerate (especially a “bank parent, nonbank subsidiary” financial conglomerate), GLBA has left yet another loophole. Because banks in the United States are prohibited from declaring dividends except under very limited circumstances, banks are not barred from distributing under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies. See 12 U.S.C.A. §371c-1(a)(1)(A)(B).

See generally Gramm-Leach-Bliley Act, supra note 6.


Id.

Section 18 (b) of Federal Deposit Insurance Act provides:
dividends to their parent financial holding companies as long as the distribution will not lead banks to default. Thus, if a bank “upstreams” its capital in the form of dividends to its parent holding company, and the holding company then “downstreams” the money to other nonbank subsidiaries through loans or other forms of credit extension, the quantity restriction established by 23A and 23B will be avoided because the distribution of dividends is not a covered transaction, and the extension of credit from the holding company to the nonbank subsidiaries is beyond the coverage of 23A and 23B.

2. **Interbank Liabilities**

United States federal law imposes restrictions on an insured depository institution’s exposure to another depository institution to limit the risks posed to insured depository institutions when large depository institutions fall. The following transactions between depository institutions may be considered “exposure”:

(A) all extensions of credit to the other depository institution, regardless of name or description, including -- (i) all deposits at the other depository institution; (ii) all purchases of securities or other assets from the other depository institution subject to an agreement to repurchase; and (iii) all guarantees, acceptances, or letters of credit (including endorsements or standby letters of credit) on behalf of the other depository institution; (B) all purchases of or investments in securities issued by the other depository institution; (C) all securities issued by the other depository institution accepted as collateral for an extension of credit to any person; and (D) all similar transactions that the Board by regulation determines to be exposure for purposes of this section.

No insured depository institution shall pay any dividends on its capital stock or interest on its capital notes or debentures (if such interest is required to be paid only out of net profits) or distribute any of its capital assets while it remains in default in the payment of any assessment due to the Corporation; and any director or officer of any insured depository institution who participates in the declaration or payment of any such dividend or interest or in any such distribution shall, upon conviction, be fined not more than $1,000 or imprisoned not more than one year, or both: Provided, That, if such default is due to a dispute between the insured depository institution and the Corporation over the amount of such assessment, this subsection shall not apply if the insured depository institution deposits security satisfactory to the Corporation for payment upon final determination of the issue.

51 12 U.S.C. §371b-2 (c) (1).
Although this section applies to both the general correspondent\textsuperscript{52} and the commonly-controlled correspondent\textsuperscript{53} of an insured depository institution, its utility in mitigating large exposure within financial conglomerates is significant. The Federal Reserve Board further issued Regulation F that provided prudential standards for banks to limit the risk arising from interbank liabilities at the time of the failure of correspondents. Under Regulation F, a bank is required to “establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent in relation to the condition of the correspondent.”\textsuperscript{54} Policies and procedures established by a bank to take into account credit and liquidity risks, including operational risks, in selecting correspondents and terminating those relationships are also required.\textsuperscript{55} Furthermore, where the financial condition of the correspondent and the form of maturity of the exposure create a significant risk that payments will not be made in full or in a timely manner, a bank’s policies and procedures shall limit the bank’s exposure to the correspondent, either by the establishment of internal limits or by other means.\textsuperscript{56}

Section 371b-2 and Regulation F did enable a bank to create formal internal procedures to monitor, assess, and manage its exposures to correspondents within the same financial conglomerate. The only drawback is that because Section 371b-2 and Regulation F were promulgated before the GLBA, insurance companies and securities firms are excluded from the definition of “commonly-controlled correspondent” because of the prohibition of the affiliation between banks and insurance and securities businesses. Thus, the expansion of

\textsuperscript{52} According to the Federal Reserve Board’s Regulation F, “correspondent” is defined as “a U.S. depository institution or a foreign bank, as defined in this part, to which a bank has exposure, but does not include a commonly controlled correspondent.” See 12 C.F.R. § 206.2(c).

\textsuperscript{53} According to the Federal Reserve Board’s Regulation F, “commonly-controlled correspondent” is defined as “a correspondent that is commonly controlled with the bank and for which the bank is subject to liability under section 5(e) of the Federal Deposit Insurance Act. A correspondent is considered to be commonly controlled with the bank if: (1) 25 percent or more of any class of voting securities of the bank and the correspondent are owned, directly or indirectly, by the same depository institution or company; or (2) Either the bank or the correspondent owns 25 percent or more of any class of voting securities of the other.” See 12 C.F.R. § 206.2(b).

\textsuperscript{54} 12 C.F.R. § 206.3 (b)(1).

\textsuperscript{55} 12 C.F.R. § 206.3 (b).

\textsuperscript{56} 12 C.F.R. § 206.3 (c).
the coverage of this act is worth considering to fulfill the supervisory needs in the post-GLBA era.

3. New York State Insurance Laws and Regulations

Because the authority of supervising insurance companies belongs to state insurance regulators, a uniform federal insurance code does not exist. New York Insurance Law is recognized as the most well-equipped and sophisticated insurance legislation within the entire United States; therefore, the following discussion is based on New York Insurance Law.

With regard to transactions within a holding company system, Article 15 of New York Insurance Law lists four types of transactions subject to the prior approval of the New York Insurance Superintendent: (1) sales, purchases, exchanges, loans or extensions of credit, or investments, involving more than one-half of one percent but less than five percent of the insurer's admitted assets at last year-end; (2) reinsurance treaties or agreements; (3) rendering of services on a regular or systematic basis; and (4) any material transaction, specified by regulation, which the superintendent determines may adversely affect the interests of the insurer's policyholders or shareholders.57 Both the extensions of credit between members of the holding company system and reinsurance agreements can cause concentration and risk transfer. The purpose of this section is, indeed, to protect policyholders. The problems of risk concentration and risk contagion can lead to systematic risk and shake the stability of the whole insurance holding company system, ultimately impacting the interests of policy holders and shareholders. Consequently, the insurance regulator plays the role of "gatekeeper" to judge whether listed transactions would cause risk concentration and risk contagion and to decide whether to approve or disapprove the transaction.58

New York Insurance Law imposes disclosure requirements that force insurance holding companies to disclose information that may materially affect the operation of the insurance holding company

57 See NY CLS Ins. §1505 (d) (2002).
58 According to Section 1505 (d) of N.Y. Insurance Law (2002), "the following transactions between a domestic controlled insurer and any person in its holding company system may not be entered into unless the insurer has notified the superintendent in writing of its intention to enter into any such transaction at least thirty days prior thereto, or such shorter period as he may permit, and he has not disapproved it within such period."
In addition, if the regulator has cause to believe that the operations of a holding company or controlled subsidiaries may materially affect operations, management, or the financial condition of any controlled insurer within the system and if the regulator is unable to obtain relevant information from said controlled insurer, the holding company and every controlled person within a holding company system should be subject to examination by order of the regulator. The problems of risk concentration and risk contagion can certainly materially affect the operation of the insurance holding company system in such a way that the holding company is duty bound to disclose it and thus trigger an examination by the regulator. Given that the examination covers "the holding company and every controlled person within a holding company system," the examination should be supervised on a group-wide basis that enables the supervisor to discover the risk concentration and risk contagion at an early stage.

4. The Glass-Steagall Act

The Glass-Steagall Act used to forbid affiliation between banks and firms engaged principally in the investment banking business. This prohibition was repealed by the Gramm-Leach-Bliley Act. However, some sections of the Glass-Steagall Act containing "flat" unambiguous prohibitions on securities activities by banks and restrictions on commercial banking by securities firms are still in force. These sections may be considered the necessary "firewall" between banks and securities firms to prevent risk concentration and risk contagion from occurring. Section 16 addresses the intended separation between commercial banks and investment banks from the commercial banking perspective. It prohibits national banks from underwriting, selling, or dealing in securities. Section 21 approaches the problem from the investment banking perspective by prohibiting investment bankers from offering checking or savings accounts. Since commercial banking products are risk-averting products and most investment banking products are risk-pursuing products, allowing the two businesses to be conducted within a single firm may lead to serious problems, including risk concentration.

59 NY CLS Ins. §1504 (a) (2002).
60 NY CLS Ins. §1504 (d) (2002).
62 Gramm-Leach-Bliley Act, supra note 6.
63 Macey, supra note 25, at 716.
and conflict of interest. Thus, the above-mentioned sections should ideally be retained for an effective regulatory structure.

5. The Gramm-Leach-Bliley Act

In regards to permission for affiliation between banks and securities firms, and between banks and insurance companies, the Gramm-Leach-Bliley Act (GLBA) provides another important feature: "functional regulation." Prior to the passage of GLBA, financial institutions were regulated along industry lines. Under the functional regulation system, regulatory authority is allocated on the basis of the nature of the activity being performed, rather than on the basis of the institutional identity of the firm conducting the activity. Also, because of criticism that individual financial institutions are being regulated by several regulators simultaneously, some of these complex financial institutions' myriad activities might not receive the appropriate level of scrutiny. The GLBA charged the Federal Reserve with the regulatory responsibility of overseeing all financial services organizations from a safety and soundness perspective.

Thus, the Federal Reserve Board plays the role of "umbrella" supervisor, taking the responsibility for consolidated supervision. To fulfill this responsibility, the Federal Reserve needs to interact closely and exchange information with the primary bank, thrift, and functional regulators. Further, the Federal Reserve Board should also foster strong relationships with senior management and the boards of directors of financial holding companies (FHC's). To facilitate the function of umbrella supervision, the Federal Reserve supervisory staff, to the extent possible, should coordinate their actions with those of the primary bank, thrift, and functional regulators of the FHC subsidiaries. These coordinative actions are comprised of periodic information sharing, reviewing the examination findings of functional regulators, making available to functional regulators pertinent information regarding the

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66 Under this "entity approach," the Comptroller of the Currency regulated national banks. The Federal Reserve regulated state banks that were members of the Federal Reserve System and regulated bank holding companies. State regulators, along with the Federal Deposit Insurance Corporation (FDIC), regulated state banks that were not Federal Reserve members. The Securities and Exchange Commission (SEC) and the National Association of Securities Dealers regulated broker-dealer firms. State insurance commissioners regulated insurance companies.

67 Macey, supra note 25, at 710.

68 Id.
FHC, and reviewing internal-audit and management reports and publicly available information.\textsuperscript{69}

In addition, the Federal Reserve Board was granted authority to examine the financial holding company and functionally regulated subsidiaries under the following circumstances:

[When] (i) the Board has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution; (ii) the Board reasonably determines, after reviewing relevant reports, that examination of the subsidiary is necessary to adequately inform the Board of the systems; or (iii) based on reports and other available information, the Board has reasonable cause to believe that a subsidiary is not in compliance with this Act or any other Federal law that the Board has specific jurisdiction to enforce against such subsidiary, including provisions relating to transactions with an affiliated depository institution, and the Board cannot make such determination through examination of the affiliated depository institution or the bank holding company.\textsuperscript{70}

6. Other Sources of U.S. Financial Institution Regulation

According to the Federal Reserve’s Bank Holding Company Supervision Manual, the Federal Reserve will monitor intra-group exposures and risk concentrations as follows:

(1) The appropriate primary bank and thrift regulators will continue to monitor and enforce section 23A and 23B restrictions at the bank or thrift level. The Federal Reserve will focus on assessing whether the FHC monitors and ensures compliance with these statutory requirements. The Federal Reserve plans to begin collecting data from each depository institution subsidiary of BHC’s, including FHC’s, on their covered transactions with affiliates that are subject to section 23A and 23B and will share that data with primary bank and thrift regulators.\textsuperscript{71}

(2) Functional regulators will continue to monitor and enforce any intra-group exposure restrictions that may apply to the regulated entities under their jurisdictions.\textsuperscript{72}

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\textsuperscript{69} Bank Holding Company Supervision Manual, Federal Reserve Board (2000), at Sec. 3900.0.4.1.

\textsuperscript{70} 12 U.S.C. §1844 (c)(2)(B) (2000); Gramm-Leach-Bliley Act, supra note 6, at § 111.

\textsuperscript{71} Supra note 69, at § 3900.0.4.2.4.

\textsuperscript{72} Id.
(3) The Federal Reserve will focus on understanding and monitoring related-party exposures at the group-level, including areas such as servicing agreements, derivatives exposures, and payments system exposures, with an important focus on the extent to which a depository institution subsidiary’s risk management is dependant on transactions with affiliates.\textsuperscript{73}

(4) The Federal Reserve also will focus on management’s effectiveness in monitoring and controlling intra-group exposures and risk concentrations. The Federal Reserve will consider how an organization’s risk management process measure and manage group-wide risk concentrations.\textsuperscript{74}

In sum, these guidelines declared four important factors: (1) the firewall (restrictions on affiliate transactions), (2) the coordination between the Federal Reserve and functional regulators, (3) the supervision on a group-wide basis, and (4) the monitoring of financial conglomerates’ self-regulation.

In addition, the United States created the so-called B-O-P-E-C\textsuperscript{75} rating system, which is supposed to evaluate the financial condition and risk characteristics of each major component of the bank holding company, assess important interrelationships among the companies, and analyze the strength and significance of key consolidated financial and operational performances.\textsuperscript{76}

B. Guidelines from International Organizations

The Tripartite Group of Banks, Securities, and Insurance Regulators, and the Joint Forum of Financial Conglomerates issued several reports related to the supervision of financial conglomerates at the end of 20\textsuperscript{th} century and the beginning of the 21\textsuperscript{st} century.\textsuperscript{77} The

\textsuperscript{73} Id.
\textsuperscript{74} Id.
\textsuperscript{75} "B-O-P-E-C" is the combination of five factors evaluated in the rating process—"bank condition," "other subsidiaries," "parents," "earnings consolidated," and "capital adequacy consolidated."
\textsuperscript{76} For further details, see the Bank Holding Company Supervision Manual, Federal Reserve Board (1997), at §4070.
\textsuperscript{77} These reports are as follows:
following discussion extracts excerpts from these reports that relate to the problems of risk concentration and risk contagion.

The Risk Concentration Principles report reveals that supervisory strategy with respect to risk concentrations in a conglomerate necessarily reflects the powers that supervisors have to induce financial institutions to reduce excessive concentrations and other dangerous exposures. In all cases, supervisors should have sufficient authority to gather and safeguard information to monitor material risk concentrations across sectors and to understand how such risks are managed. At the sector level, supervisors should review whether they have sufficient powers to protect the regulated entity from problematic risk concentrations. When supervisors lack sufficient powers, they should request any additional authority they need.\(^7\)

Given that supervisory concerns emerging from risk concentrations can be mitigated by good risk management and internal control policies and supplemented by the holding of adequate capital, risk concentrations need to be monitored both in the legal entity and across the different sectors of the conglomerate to provide for the protection of the regulated entities. Thus, supervisors should take steps, directly or through regulated entities, to ensure that conglomerates have adequate risk management processes in place to manage group-wide risk concentrations. Where necessary, supervisors should consider appropriate measures, such as reinforcing these processes with supervisory limits.\(^8\)

Owing to the dynamic nature of conglomerate organizations and the ease with which risk profiles can change, supervisors should monitor material risk concentrations on a timely basis, as needed, through regular reporting or by other means to help form a clear understanding of the risk concentrations of the financial conglomerate.\(^9\)

Additionally, public disclosure of risk concentrations at the group-wide level can promote market discipline. Effective public disclosures allow market participants to reward conglomerates that

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\(^8\) Id. at 10.
\(^9\) Id.
manage risk effectively and perform sufficient disclosure, and to penalize those that have poor risk management policies and disclosures, thus reinforcing the messages provided by the supervisor. For market discipline to be effective, disclosures need to be timely, reliable, relevant, and sufficient. Given the complexity and variety of possible risk concentrations in a financial conglomerate, enhancing disclosures should include expanding the range of the most important risk concentrations in periodic financial statements, especially in annual reports, while making timely and reliable disclosures of exposures outside the normal reporting cycle as necessary to provide greater detail in response to market concerns. In short, supervisors should encourage public disclosure of risk concentrations.\footnote{Id. at 10-11.}

Risk concentrations may arise from exposures in many parts of a financial conglomerate. The effective assessment, monitoring, and control of such concentrations by supervisors is likely to require sectoral expertise, as well as a good understanding of the techniques used by other supervisors. Therefore, supervisors should communicate closely with one another to ascertain each other’s concerns and coordinate any supervisory action relative to risk concentrations within the group.\footnote{Id. at 11.}

If a financial conglomerate is exposed to risk concentrations that may affect its financial stability, supervisors should take appropriate measures with respect to regulated entities. In some cases, supervisors may elect to take preventive measures. For example, supervisors with the necessary powers may consider establishing cross-sector limits for risk concentrations. Exceeding these limits could trigger supervisory intervention directed at controlling situations affecting the viability of the regulated entities of the conglomerate. Once a problem arises, supervisory intervention almost always begins with bringing the issue to the attention of management and the board of directors and asking them to address the supervisory concern. While supervisors generally feel they have the power to seek corrective action by the entity they regulate, actions elsewhere in the conglomerate may be necessary to effectively reduce or mitigate the concentration. Where risk concentrations cut across the regulated entities of the firm, cooperation among the relevant supervisors (as well as with the primary supervisors) is also important.\footnote{Id. at 11-12.}

Techniques provided by the Tripartite Group and the Joint Forum to supervise the “risk concentration” and “risk contagion and
intra-group risk transfer" are similar. Guiding principles outlined above are also feasible here.

As already mentioned, risk contagion can be the result of a direct financial connection between a problematic entity and a healthy one. In the absence of a direct financial connection, risk contagion can result from the loss of public confidence because financial conglomerates tend to be recognized as a single economic unit by the public. Regular public disclosure can inform the public on a timely basis so as to enhance the public confidence. It has been suggested that one way of counteracting risk contagion resulting from intra-group exposures would be to establish a system of firewalls preventing regulated entities within a conglomerate from helping other entities in the same conglomerate if the provision of such help would result in the provider being in breach of its capital requirements. Moreover, the capital standards applied by some securities regulators are designed to insulate firms and, if necessary, to allow them to be wound down in an orderly and timely way without loss to customers and counterparties. However, these firms are less likely to fail as a result of a withdrawal of credit lines because their balance sheets are highly liquid. Moreover, there is no predisposition within a securities conglomerate to prop up each individual entity. In contrast, many banking groups are very sensitive to market funding. Experience has shown that, whenever difficulties arise in one part of a banking conglomerate, the psychology of the market is such that participants are quick to withdraw credit lines from (or lower credit lines for) other entities in the same group. For this reason, banking groups may be prepared to go to considerable lengths to prevent the failure of any entity bearing the group’s name.

As banks, insurance companies and securities firms are different in their respective core business activities; risks that are dominant in their businesses are also divergent. Tools of risk assessment and management are prepared on the basis of the principal risk of the financial institution. Capital requirements of different financial businesses set up by regulators are also in accordance with risks borne. In the case of intra-group risk transfer, transferors typically seek to transfer risks taken on as a part of their core business activities, while the transferee may not have adequate capital to bear the transferred risk. Also, the supervisor of the transferee may be unfamiliar with the transferred risk. Hence, if the

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84 Supra note 13, at 18-19.
85 Id.
intra-group risk transfer is not properly monitored, risks of one entity can spread to the whole conglomerate and then trigger systematic risk. The Joint Forum recommends that the regulator commence “Cross Sectoral Comparison”\(^{87}\) to discover the differences in risks, risk management techniques, and capital requirements, so as to judge whether the transferred risk can be pertinently managed and backed by adequate economic capital.

C. Public Disclosure and Market Discipline

As mentioned above, public disclosure plays an important role in preventing risk concentration and risk contagion. Effective public disclosure enhances market discipline and allows market participants to assess a financial conglomerate's capital adequacy and risk profile. Public disclosure can also provide strong incentives to financial conglomerates to conduct their business in a safe, sound, and efficient manner. Public disclosure about the nature, components, and features of capital provides market participants with important information about financial institutions' ability to absorb financial losses. This dissemination is extremely important when an entity of a financial conglomerate inherits risks from other entities through intra-group transaction. When innovative, complex, and hybrid capital instruments are a significant proportion of a financial institution's capital, it is important that they be adequately disclosed, because the characteristics of such instruments may have a significant impact on the market's assessment of the strength and integrity of a bank's capital and of the whole financial conglomerate’s capital.\(^{88}\) Through meaningful disclosure of its risk exposures, a financial institution's risk profile—that is, the risks inherent in its on-and off-balance-sheet activities at a point in time, and its appetite for taking risk—provides information about the stability of an institution's financial position and the potential of its earnings to change with market conditions.\(^{89}\) Given dynamic financial markets, a financial institution's risk profile can change very quickly. Therefore, users of financial information need measures of risk that


\(^{87}\) Id.


\(^{89}\) Id.
remain meaningful over time and that accurately reflect sensitivities to changes in underlying market conditions.\textsuperscript{90}

The Basel Committee on Banking Supervision (Basel Committee) views increased disclosure, enhanced transparency, and market discipline as becoming ever more important tools of supervision. In its 2000 report concerning market discipline, the Basel Committee\textsuperscript{91} it provided several practical guidelines.

First, the Basel Committee recommends that a financial institution should, at least annually and more frequently where possible and appropriate, publicly disclose summary information about its capital structure and the components of its capital, and the terms and conditions of the main features of capital instruments, especially in the case of innovative, complex or hybrid capital instruments.\textsuperscript{92} The Basel Committee also encourages banks to disclose their structure and process for allocating economic capital to their business activities.\textsuperscript{93} A financial institution's capital is its buffer against risk. In the case of intra-group transactions and risk transfer, since each entity usually bears different kinds of risk, a risk that is adequately backed by transferor’s capital may not be absorbed by transferee’s capital. If the capital position and strategy of an entity does not provide a sufficient buffer against the transferred risk, this type of intra-group transaction should not be permitted.

Second, the Basel Committee suggests the following:

A bank should publicly disclose qualitative and quantitative information about its risk exposures, including its strategies for managing risk. In discussing each risk area, an institution should present sufficient qualitative (e.g., management strategies) and quantitative information (e.g., stress testing) to enable users to understand the nature and magnitude of these risk exposures. Further, comparative information of previous years' data should be provided to give the financial statement user a perspective on trends in the underlying exposures.\textsuperscript{94}

\textsuperscript{90} Id.
\textsuperscript{91} Supra note 88.
\textsuperscript{92} Id. at 4-5.
\textsuperscript{93} Id. at 8.
\textsuperscript{94} Id. at 5.
Third, the Basel Committee advocates that a bank should annually and publicly, “disclose its capital ratio and other relevant information on its capital adequacy on a consolidated basis.” Sometimes, a large exposure may hide in different parts of financial conglomerates and may not be discovered by merely looking at the solo basis data. In reality, a combination of large exposures to the same counterparty in different parts of a financial conglomerate can be dangerous to the group as a whole. Thus, monitoring large exposure on a group-wide basis is necessary. The consolidated information enables users to assess the gross large exposures that the financial conglomerate bears.

While public disclosure could facilitate market discipline and improve market participants’ understanding about the risk profiles of financial conglomerates so as to increase their confidence in the stability of the healthy financial conglomerate, this function may be somewhat hampered by the operation of public choice. Benefits that financial conglomerates can obtain from intra-group transactions or other activities that may cause risk concentration and contagion are abundant. Public choice theory indicates that “legislation is supplied to groups or coalitions that outbid rival seekers of favorable legislation. Every statute tends to represent compromise because the process of accommodating conflicts of group interest is one of deliberation and consent.” Yet, there is only limited legislation requiring public disclosure of risk concentration and risk contagion. This paucity reveals that the interest groups of financial conglomerates prevail above other groups in the “bidding.” If legislators continue failing to make enforceable laws that require financial conglomerates to enhance their public disclosure, supervisors can only encourage financial conglomerates to disclose related information to the public through unenforceable methods, for example, ethical persuasion. The effectiveness of these unenforceable methods is somewhat doubtful.

V. Current Laws and Regulations Concerning the Supervision of Financial Conglomerates in China and Proposed Reforms

Under the premise of permitting the formation of financial conglomerates in the future, current laws are significantly deficient in handling the risk concentration and risk contagion problems and need to reform on a grand scale. The following discussion focuses only on

95 Id. at 6.
existing articles of current laws that may potentially address the problems of risk concentration and risk contagion even though the current laws are not specifically designed for the supervision of financial conglomerates.

A. The Law of Commercial Banks

Commercial banks in China are supervised by the People’s Bank of China. These commercial banks are required to abide by established ratios between assets and liabilities. One of these ratios is the lending limit to a single borrower. The Law of Commercial Banks provides that the “ratio between the balance of the loan of one borrower and the balance of the capital of the commercial bank must not exceed 10%.”

Except for this lending limit, no current articles in the Law of Commercial Banks discuss the capabilities of preventing risk concentration and contagion within financial conglomerates because commercial banks are prohibited from investing in nonbank entities and are not allowed to engage in any securities business. Until recently, legislators have had no need to make laws addressing problems arising from the formation of financial conglomerates.

B. Law of People’s Bank of China

The People’s Bank of China (PBC) is the central bank of China, which takes the responsibility for supervision of commercial banks and insurance companies. It has the power to demand that “banking institutions submit balance sheets of their assets, statements of profit and loss, and other financial and accounting reports and materials in pursuance of regulations.”

C. Securities Law

Securities firms in China are supervised by two regulators: the securities regulatory body and the state auditing organ. The securities regulatory body under the State Council is responsible for centralizing and unifying the supervision and administration of all stock markets in

99 Id. at Art. 43.
101 Id. at Art. 33 (1995).
the nation. The state auditing organ supervises by auditing the accounts of stock exchanges, securities companies, securities registration and settlement organizations, and securities supervision and administration organizations. The tool provided by the Securities Law to deal with the risk concentration and risk contagion problem completely isolates the securities firms, insurance companies, and banks from one another. Article 6 of the Securities Law provides that securities firms, banks, trust firms, and insurance agencies shall operate separately and be administered separately, and securities firms, banks, trust firms, and insurance agencies shall be established separately.

D. Insurance Law

The Insurance Law of PRC also prohibits insurance companies from engaging in other financial business. The fund of the insurance company may not be used to set up securities operation organizations or to invest in enterprises. Because insurance is a business that accepts risk transferred from others, Article 99 of the Insurance Law was created to prevent risk concentration. It provides that the liability for each risk unit of an insurance company—that is, the liability for the maximum possible loss caused by each insurance accident—may not exceed 10 percent of the combined total of its actual capital and accumulated fund. If there is any excess, it shall be reinsured. This restriction on taking risk from a single risk unit can still be applicable even after the permission of the financial conglomerates, as suggested below.

E. Comments and Suggestions for Managing Risk in Chinese Conglomerates

To address the problem of risk concentration and risk contagion, the Chinese government should adopt the technique of “risk avoidance.” That means taking every step necessary to avoid significantly risky persons, objects, and events. Indeed, completely prohibiting the formation of financial conglomerates can perfectly avoid such complex supervisory problems as risk concentration and risk

105 Id. at Art.99.
106 “Risk Avoidance” is one of the methods used in risk management. Besides this method, “Loss Control,” “Risk Transfer,” and “Risk Combination” are other methods used in risk management. See SCOTT E. HARRINGTON, RISK MANAGEMENT AND INSURANCE 10-11 (1999).
107 Id. at 10.
contagion. However, as already mentioned, this prohibition can impede
the development of the Chinese financial market and the growth of the
economy. This cost is far greater than the benefits gained from avoiding
the risk concentration and risk contagion problems and is inconsistent
with the first principle of risk management. Given that the United
States has successfully established some financial conglomerates while
creating effective mechanisms to tackle risk concentration and risk
contagion, the excuse that the problem is too complicated to supervise is
insufficient and lacks merit. The correct procedure would be to allow the
formation of financial conglomerates and establish a regulatory system to
deal with related, newly generated problems simultaneously.

Modern Chinese laws have a number of deficiencies regarding
the supervision of financial conglomerates. First, they fail to provide a
concrete firewall between banks and their affiliates. Although it sets up
the lending limits to a single borrower, the Commercial Banking Law
ignores other types of transactions between affiliates that can adversely
affect the condition of banks, such as the purchase of low-quality assets.
Moreover, no articles address the issue of arms-length transactions.

Second, Chinese law makes no provision for group-wide level
supervision. The allocation of authority to supervisors is in accordance
with the industry line. Each regulator is only responsible for the entity
he regulates. No coordination policies and procedures have been
established. Besides lacking a so-called “umbrella supervisor” like the
Federal Reserve Board, Chinese financial regulators are nearly unable to
detect and monitor the group-wide risk concentration and risk contagion
problems.

Third, they lack a consolidated financial report and disclosure
requirement. Without a list of transactions that have been done or are in
process of being done, regulators are unable to monitor intra-group
transactions on a timely basis. Thus, needless risk concentration and risk
contagion that can jeopardize safety and soundness are likely to occur.

Fourth, no qualified rating agencies exist in modern China to
estimate the strength of the financial conglomerates. This absence
increases the burden of regulators and leaves consumers uninformed of
the financial and managerial condition of financial conglomerates.

108 The first principle of risk management is to utilize minimum costs to
generate maximum benefits.

As discussed earlier, three types of differently structured financial conglomerates exist today: the complete integration, the bank parent and nonbank subsidiaries, and the financial holding company. The complete integration conglomerate has the advantage of sharing resources among the various departments engaged in different businesses with a maximum of flexibility. It can easily achieve both economy of scale and economy of scope. However, because the risks of the different financial sectors are most easily spread or transferred from one to another, the complete integration model has the most serious risk concentration and contagion problems.\(^1\) The bank parent/ nonbank subsidiary model can strengthen banks through extra dividends paid in and in fee incomes, and, under the principle of corporate separateness, the parent bank bears only limited liability for its financial subsidiaries, maintaining safety and soundness. Nevertheless, risk concentration and risk contagion can also occur under this model when the bank’s profitability, reputation, and the cost of its funds may be adversely affected by the failure of any of its subsidiaries.\(^10\)

As for the financial holding company model, legal separateness simplifies regulation and supervision of the banking activities of the conglomerate, and facilitates functional regulation of its nonbanking activities. Moreover, the safety and soundness of the bank can be isolated from the performance of the nonbank affiliates because the holding company acts as a cushion between them.\(^11\) The financial holding company model also best protects the government deposit insurance funds by limiting the additional risks permitted to insured depository institutions.\(^12\) The negative side of this model is that the cost of establishing the holding company can offset the benefit gained from economy of scale and economy of scope. Also, the complex structure is more easily manipulated to avoid the restriction on intra-group transactions.

Obviously, each model has its advantages and disadvantages. When pursuing higher efficiency and cost saving, the extent of risk concentration and risk contagion will be collaterally more serious and vice versa. The financial market in China is an infant market. There, management’s skills in operating a financial conglomerate and the

\(^10\) See id. at § 2.1.2 (1).
\(^11\) See id. at §2.1.2 (2).
\(^12\) See id. at §2.1.2 (3).
regulating agencies’ skills in supervising the financial conglomerate are still immature. This immaturity begs the question as to whether supervisors are competent enough at this stage to handle the rapid development of risk concentration and risk contagion in the completely-integrated model of the financial conglomerate. Even in a country with strong financial markets like the U.S., conglomerates did not dare to venture into the completely-integrated system. In the early stages of Chinese market liberalization, the financial holding company system is more feasible. In the case of financial subsidiaries, even though they may be permitted to engage in a broader range of activities than their bank parent, the segregation between the bank and the subsidiary must be clear and absolute in order to prevent risk contagion. When bank assistance given to the subsidiary weakens the financial condition of the bank, it should be prohibited and the bank should be required to divest itself of risky activity.

1. Risk Management Mechanisms Addressing Risk Concentration and Contagion in Chinese Conglomerates

To establish a system capable of dealing satisfactorily with risk concentration and risk contagion in fledgling Chinese financial conglomerates, the following mechanisms need to be created:

(1) A system of firewalls preventing regulated entities within a conglomerate from helping other entities in the same conglomerate if the provision of such help results in the provider being in breach of its capital requirements and causes unsound banking practice. Restrictions like those of 23A and 23B of the Federal Reserve Act should also be imposed on transactions that can lead to risk concentration and risk contagion.

(2) Steps taken by supervisors, directly or through regulated entities, to ensure that conglomerates have adequate risk management processes in place to manage group-wide risk concentrations. Where necessary, the supervisors should consider appropriate measures, such as reinforcing these processes with supervisory limits. Given the dynamic nature of the activities and structure of financial conglomerates, it is also essential to ensure that financial conglomerates adjust their risk management policies and procedures in accordance with their structural and operational changes.

(3) Laws and regulations that grant supervisors the authority to monitor material risk concentrations on a timely basis through regular reporting or by other means that help form a clear understanding of the risk concentrations of the financial conglomerate. This control should
include the establishment of a financial conglomerate rating system to help in providing concrete supervisory information.

(4) A public disclosure system that enables supervisors to pierce the complex organization of financial conglomerates and to understand their overall managerial and financial condition. This system would also provide the public with better understanding of the stability of financial conglomerates, thus strengthening public confidence. Public disclosure should at least inform the public about which entities within the conglomerate are safe and sound, about the segregation of each entity, and about the limited liability of the holding company. Financial conglomerates would also be required to provide their risk management policies and procedures regarding risk concentration and risk contagion, and to prepare consolidated data.

(5) A coordination system. Specifically, an information-sharing system that helps supervisors to exchange supervisory information, to meet and discuss supervisory problems they have detected, and to cooperate to handle risk concentration and risk contagion problems. It would be best for supervisors to have a formal system for sharing information with each other and even with foreign financial regulators — for example, in the form of administrative agreements or treaties — in order to exchange information on a timely basis.\(^{113}\)

(6) Contact between supervisors and senior management of financial conglomerates. This contact is especially crucial when supervisors discover problems through inspection or through sharing with other supervisors.

2. Treatment of Foreign Competitors

There are five main types of regulatory models concerning the foreign financial institutions: (1) the “home country regulation,”\(^{114}\) (2) the “national treatment,”\(^{115}\) (3) the “special dispensation,”\(^{116}\) (4) the

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\(^{113}\) Techniques for building a formal information sharing system are clearly addressed in *The Supervision of Financial Conglomerates*, The Joint Forum of Financial Conglomerates (1999).

\(^{114}\) Home Country Regulation means a country could allow a foreign bank to conduct business in the host nation under the same terms and conditions as those that apply to the foreign bank in its home country. *See* Macey, *supra* note 36, at 800.

\(^{115}\) National Treatment means foreign banks operating in one country are treated as if they were domestic banks of that country. *Id.*

\(^{116}\) Special Dispensation means foreign banks would be given special powers not enjoyed by domestic banks. *Id.*
The current system in China seems to be the “special control” model.

The special control model is not only inconsistent with the core spirit of GATS and WTO, but it can also be a distraction to investments of foreign financial groups. Yet, international standards addressing problems of risk concentration and risk contagion do exist. If China can establish mechanisms in accordance with these standards as stated above, “the national treatment” model can not only better maintain the stability and soundness of the financial market in China but can also create a commonly acceptable and nondiscriminatory environment for foreign competitors. Such a system would resemble the United States’ national treatment system, in which the Federal Reserve may impose restrictions and requirements on the conduct of activities by foreign banks or companies comparable to those imposed on a financial holding company organized under the laws of the United States. These restrictions include a requirement to conduct activities in compliance with any prudential safeguards as long as due regard is given to the principle of national treatment and equality of competitive opportunity. Thus, national treatment presents the most feasible model.

3. The Structure of Regulators

The supervision of financial conglomerates requires effective, efficient, accountable, and independent regulators. In economically developed countries, two major types of regulators exist: the “unified regulator” (single regulator) and the “separate specialist regulator” (multiple regulators). The former exists in the United Kingdom

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117 Special Control means foreign banks would be regulated more than domestic banks. Id.
118 Reciprocity means foreign banks would be allowed to conduct operations in one country to the same extent that the foreign banks’ home country permits the host country’s bank. Id.
120 The Financial Service Authority (FSA) is responsible for the supervision of deposit takers, the supervision of insurance firms, and the regulation of investment firms. Recently, it has set up a Major Financial Groups division in order to take a coherent and integrated approach to supervising these groups. A major financial group is typically large, operates within a complex structure, is active in two or more of the main sectors of financial business (banking, insurance, and investment business), and has extensive international reach. Detailed information available at http://www.fsa.gov.uk/approach/2_themes.html.
Japan, the latter in the United States. Which system is more effective remains a highly disputed issue.

Advocates of the unified regulator system assert that separate regulators cannot easily detect group-wide risk, as they only have jurisdiction over a given portion of a diversified conglomerate. Also, the unified regulator's arrangements are more flexible than those of separate specialist regulators. Finally, unification can result in cost savings due to a shared infrastructure, administration, and support system. Unification advocates further allege that, (1) the effectiveness of separate regulators may be impeded by "turf wars" or a desire to "pass the buck," in that there is likely to be an overlap of supervisory authority, responsibilities, and skills; (2) different agencies may not share common objectives; and (3) maintaining multiple agencies is not cost-effective.

On the other hand, opponents of a unified regulator system contend that unified regulators do not strike an appropriate balance between the different objectives of regulation. Given the diversity of these objectives, a single regulator may not have a clear understanding of the various goals and rationales to adequately differentiate between institutions. Also, a unified regulator may be more inefficient, as it is usually associated with a monopoly and tends to be quite bureaucratic. This may eliminate healthy regulatory competition. Lastly, merging existing agencies or creating a single new agency requires difficult-to-obtain political agreement among government agencies. Advocates also think that the separate specialist regulator has stronger expertise on each regulated business and is thus more capable of facilitating healthy competition between regulators, making it the preferable model.

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122 Following the promulgation of the Gramm-Leach-Bliley Act, the Federal Reserve Bank now supervises financial and bank holding companies, and acts as an "umbrella supervisor." Other financial institutions are regulated by their functional regulators respectively. See Gramm-Leach-Bliley Act, supra note 6, at § 111.
125 Supra note 124.
126 Id.
With respect to the current allocation of power of Chinese financial regulators, the People's Bank of China has authority to supervise both commercial banks and insurance companies. These actions or powers resemble the unified regulator system. The role of the securities regulators resembles the separate specialist regulator system. Since no research clearly indicates that either type of structure is better than the other, as long as China adjusts the structure of its financial supervisors in accordance with one of the two types, the weaknesses of the current system could possibly be eliminated.

VI. Conclusion

The overall benefits of permitting the formation of financial conglomerates in China outweigh the adverse effects. However, group-level risk management problems, including risk concentration and risk contagion, need the attention of both supervisors and financial conglomerate management. Risk concentration may occur at the group level and can lead to systematic risk. Risk contagion reflects public confidence about the stability of the whole financial conglomerate. Either problem can result in the collapse of the financial conglomerate and can shake the foundation of the nation's financial market if not adequately regulated and managed.

As conglomerates evolve, the complexity of risk concentration and contagion increases. Thus, analytical information demands for risk management grow. Consolidated supervision and a sharing system between supervisors and conglomerate management are crucial. It is also important to ensure that financial conglomerates have a system to adequately measure, monitor, manage, and control risk concentration and risk contagion at group-wide level as part of the risk management program. An independent rating agency should be granted the mission of evaluating the risk management systems of financial conglomerates.

As has already been proposed, to prevent excessive risk concentration and risk contagion, it would be prudent to build a firewall between different entities of a financial conglomerate in order to restrict the financial connections and prevent financial difficulties occurring in one entity from affecting another. Although this comment does not specifically address the debate about the function of the firewall, it is worth noting that there is much dispute as to how firewalls should be built. Without doubt, its controlling status gives the parent holding company a responsibility for the risks run by its subsidiary. The holding

127 Van den Berghe & Verweire, supra note 10, at 162. See also Koguchi, supra note 14, at 31.
company tends to be unwilling to see its subsidiary in trouble because that can result in the loss of both its investment and its reputation. In other words, it is in the holding company’s interest to rescue its subsidiary through intra-group transactions. A firewall that is too high may impede the financial conglomerate’s attainment of this benefit and therefore offset the efficiency of financial conglomerates. The firewall, although it can reduce risk concentration and risk contagion, is unable to prevent the subsidiary bank or insurance company of a financial conglomerate from failing in such a way as to cause the loss of the governmental deposit insurance fund or insurance guarantee fund. From this perspective, it might be unwise to bar the holding company from helping its bank or insurance subsidiary. Thus, balancing the benefits between the reduction of risk concentration and risk contagion and the protection of deposit insurance and insurance guarantee fund remains a task for regulators and legislators.

There is no doubt that public disclosure is necessary to facilitate market discipline and strengthen public confidence. Yet, this goal seems difficult to achieve. As already mentioned, financial conglomerates enjoy large benefits generated from intra-group transactions or other activities that may cause risk concentration and contagion. Under the public choice theory, “legislation is supplied to groups or coalitions that outbid rival seekers of favorable legislation.” The fact that legislation requiring public disclosure about risk concentration and risk contagion is limited to some extent reflects that the interest group of financial conglomerates prevails over other groups in the process of legislation. If legislators continually fail to make enforceable laws that require financial conglomerates to enhance their public disclosure, how can regulators successfully urge them to improve their public disclosure through unenforceable ethical persuasion?

At present, the supervisory system of financial conglomerates in China is virtually nonexistent. Even if its reform in the future brings it in line with international standards, there will still be no guarantee of its success in preventing the problems of risk concentration and contagion. Obviously, no system is perfect. As outlined above, commonly accepted tools like firewalls and public disclosure have their own challenges. Nevertheless, a supervisory system that rapidly responds to frequent changes in the complex structure and variable business of financial conglomerates...
conglomerates, and that effectively implements laws and regulations is most likely to succeed.