

China Proposes an Overarching Financial Stability Law to Prevent Financial Risks and Maintain Financial Stability

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On April 6, 2022, the People's Bank of China, together with the National Development and Reform Commission, the Ministry of Justice, the Ministry of Finance, the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission, and the State Administration of Foreign Exchange, drafted the "Financial Stability Law of the People's Republic of China (Draft for Comments)" (hereinafter referred to as the "Draft of Financial Stability Law" or "Draft"), and solicit comments from the public (the deadline for feedback is May 6, 2022). This article briefly looks at its legislative background, significance of promulgation, and analyzes the risk prevention and control mechanism that it proposes.

I. The legislative background and the significance of the Financial Stability Law

Proposals from industry and academia for the establishment of the Financial Stability Law have appeared many times as early as the beginning of the 21st century. In recent years, the turbulent international situation and the pattern of China's own economic development have accelerated the promulgation of the Draft of Financial Stability Law. Since 2020, the global spread of the Covid-19 pandemic and the world's worst economic recession since World War II have made the economic situation at home and abroad increasingly severe and complicated. At this moment, the overall risk prevention and control capabilities of a state are particularly important. The course of China's economic development also reflects the need for financial risk prevention.

In 2020, the Fifth Plenary Session of the 19th Central Committee of the Communist Party of China proposed the "14th Five-Year Plan," one goal of which is to continuously improve the regulatory system and mechanism to prevent and resolve material risks, especially financial risks. According to the 14th Five-Year Plan, the financial risk prevention and control measures on the macro-level perspective include the following three important aspects: first, build a modern central bank system, improve the money supply regulation mechanism, and facilitate the market-based interest rate formation and transmission mechanism; second, construct financial systems and mechanisms to effectively support the real economy, enhance the inclusiveness of financial services, and increase the proportion of direct financing; third, improve the modern financial supervision system, and refine the financial risk prevention, warning, disposal, and accountability system. At the National People's Congress and the Chinese People's Political Consultative Conference in 2021, many representatives suggested the establishment of the Financial Stability Law. In August 2021, the 10th meeting of the Central Finance and Economics Commission made the "Report on Preventing and Resolving Material Financial Risks, and Pursuing Stable Developments in Finance," and continued to focus on the stability of the financial

market. Thereafter, the People's Bank of China accelerated the formulation of the Financial Stability Law in response to the report, and the government work report in March 2022 further mentioned that a Financial Stability Guarantee Fund should be established to promptly deal with financial risks in a systematic manner.

The promulgation of the Draft of Financial Stability Law plays an important strategic role in maintaining the state's long-term stability, establishing a fully coordinated and organized financial stabilization mechanism, and making up for the shortcomings of the risk disposal system. Liu Guiping, the deputy governor of the People's Bank of China, wrote in the sixth issue of "China Finance" in 2021 that a "Financial Stability Law" was imperative to have as it would: (1) meet the urgent needs to prevent and resolve systemic financial risks; (2) timely conclude and codify the experience of the resolution and disposal of domestic financial risk, and improve the financial stabilization mechanism; (3) solve the substantial problems in the financial stability task and ensure the smooth implementation of the next stage of financial risk prevention and resolution; (4) draw on the experience of international regulatory reform for China; and (5) strengthen the top-down design and overall coordination of financial stability and improve the financial regulatory system.

II. Main Contents of the Draft

The Draft has 6 chapters and 48 provisions, consisting of the general provisions, financial risk prevention, financial risk resolution, financial risk disposal, legal responsibilities, and supplementary provisions. Its main contents include:

A. Improve the regulatory mechanism of financial stability

- The National Financial Stability and Development Coordination Mechanism (Financial Committee of the State Council) shall, acting as the coordinator for financial stability, reform, and development, direct and carry out the prevention, resolution, and disposal of material financial risks, and submit substantial matters for approval as necessary according to relevant procedures.
- The relevant government agencies and local governments shall, in accordance with the division of responsibilities and the requirements of the Finance Committee, perform their duties of preventing, resolving, and disposing of financial risks in accordance with the law, and closely coordinate and cooperate to form a joint effort.
- Deposit Insurance Fund management institutions and Industry Security Fund management institutions shall perform their duties in accordance with the law, and play the role of market-based and law-based disposal platforms.

B. Emphasis on licensed operation

No unit or individual may establish a financial institution without approval, and may not engage in or engage in disguised forms in financial business activities.

C. Consolidate the responsibilities of all parties for financial risk prevention, resolution, and disposal

- Consolidate the subject responsibilities of financial institutions and their major shareholders and actual controllers, strengthen financial institutions' prudential operation obligations, and strengthen access and regulatory requirements for major shareholders and actual controllers.
- Consolidate the stability maintenance responsibilities of local governments, and proactively resolve regional financial risks in a timely manner.
- Consolidate the regulatory responsibilities of the financial regulatory authorities, earnestly perform the responsibilities of financial risk prevention and control in each sector of the financial industry, and strictly prevent, correct and deal with risks in a timely manner.
- The People's Bank of China plays the role of the lender of last resort and maintains the bottom line of preventing systemic financial risks.

D. Establish a disposal fund pool, set up a fund arrangement for disposal that is fair and orderly

- First, the institutions being disposed of are required to proactively rescue themselves from risks. Its major shareholders and actual controllers shall replenish capital in accordance with the recovery and disposal plan or regulatory commitments, and shareholders and actual controllers who are responsible for financial risks shall perform self-rescue obligations.
- At the same time, mobilize market-based funds to participate in the merger, acquisition and reorganization of the disposed institutions, and give play to the regulatory role of Deposit Insurance Funds and Industry Security Funds as a market-based and law-based disposal platform.
- If regional stability is endangered, and it is still difficult to resolve the risk after exhausting market-based measures and strictly implementing the recovery of assets and losses, local public resources shall be used in accordance with the law.
- If material financial risks endanger financial stability, the Financial Stability Guarantee Fund shall be used in accordance with regulations to effectively prevent moral hazards and keep market discipline.

E. Establishment of the Financial Stability Guarantee Fund

The Draft proposes to establish the Financial Stability Guarantee Fund as a state reserve fund for the disposal of material financial risk.

F. Establish a market-based and legal-based risk disposal mechanism

- The Draft provides for additional disposal tools such as the overall transfer of assets and liabilities, the establishment of bridge banks and special purpose vehicles, and the suspension and termination of netting settlement.
- It is clarified that the disposal institutions can implement equity, debt write-down and debt-to-equity swaps in accordance with the law so as to distribute disposal costs.

- The Draft provides for the order of write-down of equity and creditor's rights, and specifies that the income of creditors and relevant stakeholders from risk disposal shall not be lower than the income from bankruptcy liquidation.

G. Strengthen accountability for violations of laws and regulations

H. Cross-border cooperation on disposal

In accordance with the principle of reciprocity and mutual benefit, the financial management department of the State Council shall carry out information sharing and supervision cooperation with overseas regulatory authorities, so as to deal with cross-border financial risks in a timely and effective manner and prevent cross-border contagion of risks.

I. Scope of application

The Financial Stability Law shall apply to the branches of overseas financial institutions and overseas financial infrastructures established within the territory of the People's Republic of China. If the People's Republic of China and other countries or regions have other arrangements for maintaining financial stability, the relevant arrangements shall be followed.

III. A brief analysis of the risk prevention and control mechanism established by the Draft

The Draft of Financial Stability Law establishes a full-process and full-chain arrangement of financial risk prevention and control system. The arrangement consists of three main processes, namely prevention in advance, resolution during the event, and disposal after the event. Some featured mechanisms of these processes are analyzed as the follows:

A. Prevention in advance

The Draft of Financial Stability Law focuses on risk prevention in the risk control mechanism, and its Chapter 2 is devoted to "financial risk prevention." There are 9 articles in this chapter, which seek to prevent risks from occurring via a combination of means including emphasizing licensed operation, consolidating the responsibility of the subjects, strengthening qualification control of shareholders and actual controllers, and clarifying the prohibited behaviors of shareholders and actual controllers.

In terms of the qualification of shareholders, the Draft summarizes the practice of shareholder supervision of financial institutions in recent years, emphasizing that the major shareholders and actual controllers of financial institutions should have good capital strength, financial status, and integrity records, and comply with the prudential conditions stipulated by laws and administrative regulations. Non-financial enterprises that act as the major shareholders or actual controllers of financial institutions, should also have a standardized corporate governance structure, a clear shareholding structure, and a solid risk management and internal control mechanisms. In respect of

shareholder responsibility, the Draft emphasizes that it does not allow false capital contributions, capital withdrawal, concealment and provision of false financial accounting reports, etc., and prohibits the actual controller of a financial institution to cover up the actual control by means of entrusted equity holding on behalf of others and concealment of interested party transactions.

In addition, the Draft incorporates the recovery and disposal plan into corporate governance, and requires that financial institutions that meet the requirements prescribed by the financial regulators shall formulate recovery and disposal plans and provide for arrangements for resuming continuous operations and orderly disposal when material risks occur.

B. Resolution during the event

In terms of resolution during the event, the first thing to implement is the subject responsibility of the financial institution itself. Upon the occurrence of risk events such as abnormal fluctuations in regulatory indicators, financial institutions shall, according to the circumstances, take measures such as reducing the scale of assets and liabilities, suspending relevant businesses, liquidating assets, replenishing capital, suspending distribution of dividends, and restricting remuneration of directors, supervisors, and senior executives to proactively resolve risks. In addition, the Draft also clarifies local governments' responsibilities for resolving financial risk within their territories, as well as regulatory authorities' responsibilities within their industries.

C. Disposal after the event

i. Sources of disposal funds and order of use

To reduce their reliance on public funds in the disposal of risks, the Draft adheres to the principle that financial institutions must first bail out themselves and then take external aid. It clarifies that in the process of financial risk disposal, relevant funds and resources should be used in order, that is, the major shareholders and actual controllers of financial institutions are first required to replenish capital in accordance with the recovery and disposal plan or regulatory commitments, and shareholders and actual controllers who are responsible for financial risks shall rescue the disposed financial institutions. Then, market-based funds may be mobilized to participate in the merger and reorganization of the disposed financial institutions, and the Deposit Insurance Fund and the Industry Guarantee Fund may provide capital contributions. Where regional stability is endangered and market-based means have been exhausted, local public resources are to be tapped. Finally, the Financial Stability Guarantee Fund is to be mobilized when material financial risks are involved and financial stability is endangered. To sum up, the order of funds use is: the major shareholders and actual controllers of the disposed financial institutions → market-based funds → Deposit Insurance Funds and Industry Guarantee Funds → provincial and local finance → Financial Stability Guarantee Funds. The order is in line with the concept of marketization and rule of law, and also reflects the purpose of consolidating the subject's responsibility and preventing moral hazard.

ii. Financial Stability Guarantee Fund

On March 5, 2022, the government's work report proposed for the first time to "establish a Financial Stability Guarantee Fund, resolve potential risks in market-based and legal-based manners, and guard the bottom line of non-occurrence of systemic risks." On March 25, the official website of the China Banking and Insurance Regulatory Commission pointed out that the task related to the establishment of the Financial Stability Guarantee Fund is being studied and advanced. It is initially considered that the Financial Stability Guarantee Fund should be used for the disposal of material risks with systemic hidden danger, that it is to be collected from the market and used in the market, and that it should charge fees at differentiated rates for different industries and entities so as to balance risks, benefits, and responsibilities, and avoid losses to the state and taxpayers. The Draft codifies this concept, and its Article 29 sets out a framework of systematic arrangement for the Financial Stability Guarantee Fund:

a. Sources of the Fund: It is composed of funds raised from financial institutions, financial infrastructure, and other entities, as well as other funds prescribed by the State Council. Looking at the experience of western countries, it is expected that "other funds" may include fiscal grants and debt financing by the Financial Stability Guarantee Fund. When necessary, public funds such as PBOC refinancings can be used to provide liquidity support for the Financial Stability Guarantee Fund, which the Financial Stability Guarantee Fund shall repay by way of disposal proceeds, incomes, and industry fees.

b. Use of the Fund: The detailed arrangement in relation to the collection, management and use of Financial Stability Guarantee Funds shall be prescribed by the State Council.

c. Targeting: The Fund shall serve as a reserve fund to fend off material financial risks and as such shall be coordinated and managed by the coordinating mechanism for national financial stability and development.

iii. Resolution measures and tools

The Draft authorizes the financial regulators to take a series of disposal measures in different situations in the disposal of financial risks. These measures include taking over the operation and management of the disposed institution, transferring business, assets, and liabilities to a third party, setting up bridge banks and special purpose carriers to undertake business, assets, and liabilities, suspending the termination of netting settlement, ordering the replacement of relevant responsible personnel and recovering performance compensation, writing off equity and debt, and making debt-to-equity swaps, suspending the transfer of funds from the disposed institution to the mainland or requiring it to recall overseas assets. Requiring group parents of the important disposed institution to provide assistance, and etc.

In recent years, China has established many mechanisms and systems in the practice of corporate bankruptcy and reorganization, but the toolbox is not rich enough for the

disposal of financial risks. The Draft provides for additional tools, one of which is the transfer of the business, assets and liabilities of the disposed financial institution to a third-party institution, bridge bank, or special purpose vehicle. Article 31 of the Draft stipulates that if the assets and liabilities of the financial institution to be disposed of are transferred as a whole, the creditors and relevant stakeholders may be notified by means of an announcement, and that "[t]he disposal measures will take effect when the announcement is issued, and the business qualifications, litigation subject qualifications, and litigation status of the disposed financial institutions shall be inherited by the assignee." According to the general principles and practices of China's Company Law, a company generally requires the creditor's consent or at least a certain notice period to dispose of all its assets and liabilities, and the assignee cannot inherit business qualifications. Article 31 would obviously speed the process up in a financial risk disposal scenario. In addition, Article 35 of the Draft also stipulates that for bridge banks and special-purpose vehicles that are the subject of the undertaking, the financial authorities may exempt or modify some of the regulatory requirements. In fact, during the disposal of Baoshang Bank, the method of asset transfer was used to a certain extent, and the newly established Mengshang Bank took over the assets and liabilities of Baoshang Bank's head office and Inner Mongolia sub-branch. We expect that the provisions of the whole transfer method in the Draft will lay a legal foundation for the full use of this tool.

Another highlight is that for the first time, the Draft empowers the financial management department to implement equity, debt write-down (which should be implemented in the order of equity, subordinated debt, and ordinary debt), and debt-to-equity swaps for the disposed financial institution, and stipulates that the equity of a shareholder shall be written down in full if the equity interests of the shareholder in the disposed financial institution are not enough to make up for the assets loss of the disposed financial institution, and the shareholder refuses to make additional capital contribution at all or in an amount enough to make up for the asset loss. Under China's current regulatory system, although some regulations stipulate that financial authorities can mandate relevant shareholders to transfer equity or restrict shareholders' rights under certain circumstances, the relevant rules are the departmental regulations and do not provide sufficient legal ground. The "China Financial Stability Report" released by the People's Bank of China in September 2021 pointed out that one of the obstacles to disposals of high-risk financial institutions is that the financial regulators lack the necessary power of disposal. From the perspective of international practice, the disposal authority is generally given the power to write down the equity or other capital instruments of the financial institution being disposed of, while in China this was not the case; as such, equity could not be compulsorily adjusted unless in a bankruptcy process; and in the administrative disposal stage, although the financial management department could mandate shareholders to transfer equity, the force of execution was insufficient. This provision in the Draft makes up for this shortcoming.

At the same time, the Draft also pays attention to the protection of the rights of creditors. According to the Draft, if the creditors and relevant stakeholders believe that

in the risk disposal implemented, their income is lower than the amount they could otherwise get from a bankruptcy liquidation procedure, they may file for an administrative review, and may further bring an administrative lawsuit for compensation in front of a court if they are not satisfied with the result of the review.

IV. Trends and Prospects for Financial Regulation

In recent years, the financial supervision in China has always adhered to the keynote of seeking progress while maintaining stability, focusing on serving the real economy, and deepening financial reform and opening up. Under the enormous impact of the Covid-19 pandemic and the economic recession brought by complex international situations, the prevention and resolution of financial risks, especially systemic financial risks, has been elevated to a top priority.

The Central Economic Work Conference in 2021 calls for strengthening the construction of the financial regulatory system and sets the tone of “seeking progress while maintaining stability,” which means that the financial regulatory policy in 2022 will likely maintain continuity to ensure the national economic security. The Commercial Banking Law, the People's Bank of China Law, and the Anti-Money Laundering Law were set for preparatory review in the 2021 Legislative Plan of the Standing Committee of the National People's Congress, revised drafts of which have been published to solicit public opinions in 2020 and 2021. Similarly, the draft revision of the Insurance Law, contained in the 2021 annual legislative plan, is expected to be released. Also, the Financial Stability Law has been included in the 2022 legislative program. The promulgation and revision of these fundamental financial laws and regulations will represent a major upgrade of the existing financial regulatory regime, which we believe will strengthen the top-down design of the financial stability legal system and the overall coordination across industries and departments to prevent systemic financial risks and maintain the health and stability of the financial system.

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